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No. _____

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1993

BERTHA PAGLIN FERMAN,
as Executrix of the Estate of Jules J. Paglin,

Petitioner,

versus

UNITED STATES OF AMERICA,

Respondent.

Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTION PRESENTED

Does the Due Process Clause of the Fifth Amendment guarantee every citizen, as a basic element of fairness, the right to predict the consequences of his or her behavior under the laws of the United States? More specifically, does the Due Process Clause prohibit the Internal Revenue Service ("IRS") from retroactively denying an estate tax deduction to a citizen who executes transactions pursuant to a statute that explicitly guarantees the deduction, if the statute be later changed to bar the taxpayer's deduction but, at the time the taxpayer executed the transactions, the sole indication the statute might be changed was an IRS "notice" that flatly contradicted the clear and unambiguous language of the statute, that was not supported by any legislative history, and that was therefore a constitutional nullity?

TABLE OF CONTENTS

Page

QUESTION PRESENTED i

TABLE OF CONTENTS ii

TABLE OF AUTHORITIES iv

OPINIONS BELOW 1

JURISDICTION 2

STATUTES INVOLVED 2

I. STATEMENT OF THE CASE 2

II. REASONS FOR GRANTING THE WRIT 9

III. CONCLUSION 30

APPENDIX A: *Ferman v. United States*, 993 F.2d 485 (5th Cir. 1993) A-1

APPENDIX B: *Ferman v. United States*, 790 F. Supp. 656 (E.D. La. 1992) B-1

APPENDIX C: *Carlton v. United States*, 972 F.2d 1051 (9th Cir. 1992) C-1

APPENDIX D: 26 U.S.C. § 2057 (Supp. IV 1986) ... D-1

APPENDIX E: 26 U.S.C. § 2057 (amended) E-1

APPENDIX F: Joint Stipulation of Facts F-1

APPENDIX G: Summary of Benefits of Prior ESOP Legislation G-1

TABLE OF AUTHORITIES

Page

CASES

Adams Fruit Co. v. Barrett, 494 U.S. 638 (1990) 23

American Tobacco Co. v. Patterson, 456 U.S. 63 (1982) 24

Blodgett v. Holden, 275 U.S. 142 (1927).... 11, 12, 20, 21

Caminetti v. United States, 242 U.S. 470 (1917) 23

Carlton v. United States, 972 F.2d 1051 (9th Cir. 1992), *cert. granted*, 61 U.S.L.W. 3854 (U.S. Oct. 4, 1993) ..... *passim*

Caterpillar Tractor Co. v. United States, 589 F.2d 1040 (Ct. Cl. 1978)..... 25

City of Anaheim v. FERC, 723 F.2d 656 (9th Cir. 1984)..... 22

Eli Lilly & Co. v. Commissioner, 856 F.2d 855 (7th Cir. 1988) 21

Estate of Ceppi v. Commissioner, 698 F.2d 17 (1st Cir.), *cert. denied*, 462 U.S. 1120 (1983)..... 28

Estate of Ekins v. Commissioner, 797 F.2d 481 (7th Cir. 1986) 27

Fein v. United States, 730 F.2d 1211 (8th Cir.), *cert. denied*, 469 U.S. 858 (1984)..... 27

Ferman v. United States, 790 F. Supp. 656 (E.D. La. 1992), *aff'd*, 993 F.2d 485 (5th Cir. 1993)..... *passim*

First National Bank v. United States, 420 F.2d 725 (Ct. Cl.), *cert. denied*, 398 U.S. 950 (1970)..... 28

General Motors Corp. v. Romein, 112 S. Ct. 1105 (1992)..... 10

TABLE OF AUTHORITIES – Continued

Page

K Mart Corp. v. Cartier, Inc., 486 U.S. 281 (1988) 23

Koshland v. Helvering, 298 U.S. 441 (1936) 23

Le Croy Research System Corp. v. Commissioner, 751 F.2d 123 (2nd Cir. 1984) 22

Lewellyn v. Frick, 268 U.S. 238 (1925) 11

Manhattan Gen. Equip. Co. v. Commissioner, 297 U.S. 129 (1936) 23

Milliken v. United States, 283 U.S. 15 (1931) 26

Moskal v. United States, 498 U.S. 103 (1990) 22

Nichols v. Coolidge, 274 U.S. 531 (1927) ... 10, 11, 20, 21

Patterson v. Shumate, 112 S. Ct. 2242 (1992) 24

Pension Benefit Guaranty Corp. v. R.A. Gray & Co., 467 U.S. 717 (1984) 10, 20, 21

Purvis v. United States, 501 F.2d 311 (9th Cir. 1974), *cert. denied*, 420 U.S. 947 (1975) 28

Reed v. United States, 743 F.2d 481 (7th Cir. 1984), *cert. denied*, 471 U.S. 1135 (1985) 27

Rowan Cos. v. United States, 452 U.S. 247 (1981) 24

Sidney v. Commissioner, 273 F.2d 928 (2d Cir. 1960) 29

Sullivan v. Everhart, 494 U.S. 83 (1990) 23

Union Bank v. Wolas, 112 S. Ct. 527 (1992) 24

United States v. Calamaro, 354 U.S. 351 (1957) 23

United States v. Darusmont, 449 U.S. 292 (1981) 10, 13, 14, 20, 21

United States v. Hemme, 476 U.S. 558 (1986) 10, 14, 15, 20, 28

TABLE OF AUTHORITIES – Continued

Page

United States v. Larionoff, 431 U.S. 864 (1977) 24

United States v. Ron Pair Enter., Inc., 489 U.S. 235 (1989) 23

United States v. Sperry Corp., 493 U.S. 52 (1989)..... 10

United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982) 24

Untermyer v. Anderson, 276 U.S. 440 (1928) 11, 20

Usery v. Turner Elkhorn Mining Co., 428 U.S. 1 (1976) 10

Welch v. Henry, 305 U.S. 134 (1938)....10, 13, 20, 26, 29

CONSTITUTION

U.S. Const. art. I, § 1..... 27

U.S. Const. art. I, § 8..... 27

U.S. Const. amend. V..... 11

STATUTES

26 U.S.C. § 2057 (Supp. IV 1986)..... *passim*

26 U.S.C. § 2057 (amended)..... 6

28 U.S.C. § 1254(1) 2

Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432..... 6

Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 2

TABLE OF AUTHORITIES – Continued

Page

MISCELLANEOUS

H.R. Con. Res. 395, 99th Cong., 2d Sess., 132 Cong. Rec. §§ 16,391-93 (daily ed. Oct. 16, 1986) 3

2 Senate Comm. on Finance, 98th Cong., 2d Sess., Statutory Language of Provisions Approved by the Committee on March 21, 1984, 338-40 (S. Prt. 98-169) 3

Notice 87-13, 1987-1 C.B. 432, 442..... 4, 22, 25, 26

Statement of Assistant Secretary of the Treasury for Tax Policy J. Roger Mentz, Daily Tax Report (BNA), at G-1 (Jan. 29, 1987) 5, 26

Laurence H. Tribe, *American Constitutional Law* (2d ed. 1988) 21

Charles Hochman, "The Supreme Court and the Constitutionality of Retroactive Legislation," 73 Harv. L. Rev. 692 (1960) 13

Note, "Has Due Process Struck Out? The Judicial Rubberstamping of Retroactive Economic Laws," 42 Duke L.J. 1068 (1993) 16

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BERTHA PAGLIN FERMAN,
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Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Fifth Circuit

PETITION FOR WRIT OF CERTIORARI

Bertha Paglin Ferman, as Testamentary Executrix of the Estate of Jules J. Paglin ("Ferman"), petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at 993 F.2d 485 (5th Cir. 1993), and is reprinted in the Appendix commencing at App. A. The opinion of the United States District Court for the Eastern District of Louisiana is reported at 790 F. Supp.

656 (E.D. La. 1992), and is reprinted in the Appendix commencing at App. B.

This Court recently granted certiorari in a similar case from the United States Court of Appeals for the Ninth Circuit – *Carlton v. United States*, Docket No. 92-1941. The Ninth Circuit's opinion is reported at 972 F.2d 1051 (9th Cir. 1992), *cert. granted*, 61 U.S.L.W. 3854 (Oct. 4, 1993), and is reprinted in the Appendix commencing at App. C.

JURISDICTION

This Petition for a Writ of Certiorari seeks review of a judgment of the United States Court of Appeals for the Fifth Circuit dated June 18, 1993, affirming a summary judgment issued by the United States District Court for the Eastern District of Louisiana. The Fifth Circuit denied the petitioner's application for rehearing on July 15, 1993. This petition will have been filed within 90 days thereafter. Jurisdiction to review the judgment of the Court of Appeals is conferred on this Court by 28 U.S.C. § 1254(1).

STATUTES INVOLVED

The pertinent portions of the Constitution, the statutes, and the regulations involved in this case are cited in the Table of Authorities and reprinted either in the body of the Petition or in the Appendix in App. D and App. E.

I. STATEMENT OF THE CASE

On October 22, 1986, Congress enacted the Tax Reform Act of 1986 ("TRA"). Pub. L. No. 99-514, 100 Stat. 2085. Section 1172 of the TRA added a new estate tax provision that was codified as Section 2057 of the Internal

Revenue Code ("IRC"). 26 U.S.C. § 2057 (Supp. IV 1986); App. D. This new provision authorized estate tax deductions for all sales of an employer's stock, executed between October 22, 1986 and December 31, 1991, to a qualified "employee stock ownership plan" or ESOP. The goal of Section 2057 was to help democratize corporate governance through ESOPs. Section 2057 promoted this goal by encouraging taxpayers to sell an employer's stock to an ESOP at a discounted price. Any executrix who sold an employer's stock to an ESOP was entitled to deduct "from the gross federal estate an amount equal to 50% of [the] sale," so long as the executrix made the sale "before the date on which the [estate tax] return . . . [was] required to be filed (including any extensions)." 26 U.S.C. 2057(a)(c)(1); App. D.

Before passing the TRA at the end of 1986, Congress considered hundreds of potential amendments to the statute. All of the amendments were clerical or technical. Only one pertained to Section 2057, and it simply sought to delete an extraneous "is". *See* H.R. Con. Res. 395, 99th Cong., 2d Sess., 132 Cong. Rec. §§ 16,391-93 (daily ed. Oct. 16, 1986). None of the proposed amendments filed in 1986 would have required an executrix to satisfy any additional condition to qualify under Section 2057 for the new estate tax deduction for stock sales to an ESOP. By that point, moreover, Congress had been debating the wording of Section 2057 for over two years. *See* 2 Senate Comm. on Finance, 98th Cong., 2d Sess., Statutory Language of Provisions Approved by the Committee on March 21, 1984, 338-40 (S. Prt. 98-169).

Section 2057, as originally enacted, was a "tax expenditure" provision, which is a provision that seeks to promote a vital social goal through tax incentives. A tax

expenditure provision differs from a "tax revenue" provision. The latter, as the term suggests, is designed to raise revenues. Section 2057 was a tax expenditure provision because it was designed to promote Congress' long-standing goal of democratizing corporate governance through support of ESOPs. Most traditional estate, gift, and income tax laws, by contrast, are tax revenue measures. *Section 2057 therefore represents an anomaly – a tax provision essentially different from most other tax provisions.* Courts, moreover, have permitted laws to be applied retroactively only to tax revenue measures, and then only to certain tax revenue measures.

In early 1987, without any support in either the text or the legislative history of Section 2057, the IRS issued Notice 87-13. The IRS issued an advance version of Notice 87-13 on January 5, 1987, and then formally published the Notice on January 26, 1987. Notice 87-13, 1987-1 C.B. 432, 442. The Notice states that, "[u]ntil further guidance is published, the guidance provided by these questions and answers may be relied on by taxpayers[.]" *Id.* Question 23 of the Notice describes the IRS' view of Section 2057 as follows:

> Q-23: How does section 2057 of the Code, added to section 1172 of TRA '86, affect the sale of employer securities by an estate to an ESOP or eligible worker-owned cooperative?
>
> A-23: . . . Pending the enactment of *clarifying* legislation, the Service will treat a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative as not satisfying the requirements of section 2057, and thus the proceeds of such sale will not be treated as qualified proceeds of a qualified sale, *unless (i) the*

decedent directly owned the employer securities immediately before death. . . .

Id.

Thus, from whole cloth the IRS created a requirement that a decedent own stock before death in order for the sale to an ESOP to qualify under Section 2057. This requirement was clearly beyond the plain meaning of the statute and was not warranted under any review of the legislative history. Several days after its formal publication, the Assistant Secretary of the Treasury for Tax Policy publicly "questioned the legality" of Notice 87-13 and admitted that "[t]here is no legislative history to support it." *See* Statement of Assistant Secretary of the Treasury for Tax Policy J. Roger Mentz, Daily Tax Report (BNA), at G-1 (Jan. 29, 1987).

Relying on the plain language of Section 2057 and the statements of the Assistant Secretary of the Treasury for Tax Policy, and believing that only Congress could change the statute, Ferman executed three transactions in February 1987 for the express purpose of reaping the benefits of Section 2057. Specifically, on February 20, February 23, and February 24, Ferman purchased an aggregate of 35,700 shares of ALZA Corporation stock for $988,150.00. *See* App. F, at ¶ 10. Immediately after each purchase, Ferman sold the shares at a discount to the ALZA Employee Stock Ownership Plan ("ALZA ESOP"). *Id.* at ¶¶ 9-10. In connection with each sale, Ferman and ALZA Corporation executed the documents required by the TRA. *Id.* at ¶ 11.[1] The combined sales yielded

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[1] In those documents, ALZA Corporation consented "to the application of § 4979A of the I.R.C. (1986) (the 'Code')," pursuant to which "ALZA may be subject to tax on the amount

$932,090.50, reflecting a savings for the ALZA ESOP, and a loss to the estate, of $49,057.50. *Id.* at ¶ 10.[2]

On February 26, 1987, after Ferman had completed all of the sales to the ALZA ESOP, a bill was introduced in Congress to amend Section 2057. The proposed amendment sought to limit deductions under Section 2057 to those transactions in which the decedent "directly owned" the securities before death. The amendment eventually was adopted and became law on December 22, 1987. Omnibus Budget Reconciliation Act of 1987 ("OBRA"), Pub. L. No. 100-203, § 10411, 101 Stat. 1330-432 to 436. By its own terms, the amendment purported to apply retroactively, making the decedent ownership requirement applicable to all transactions executed after October 22, 1986, the effective date of the TRA. Pub. L. No. 100-203, § 10411, n.2, 101 Stat. 1330-432 (1987); App. E.

Several months later, Ferman filed a timely federal estate tax return reflecting a total gross estate of $2,786,691.42, with total allowable deductions of $916,852.39, for a taxable estate of $1,869,839.03. *See* App. F, at ¶ 13. The purchases of the ALZA stock and the

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involved in a prohibited allocation of qualified securities (as defined in § 409(a) of the Code) acquired by the ALZA Corporation Employee Stock Ownership Plan in a sale by the Estate . . . " *See* App. F, at ¶ 11.

[2] The transactions are set forth in Appendix F, at ¶ 10, as follows:

> The Purchase prices paid by the Estate for the 35,700 shares of ALZA stock aggregate $981,150, plus aggregate brokerage commission of $7,000, for a total cost to the Estate of $988,150. The total prices paid by

immediate resales of the stock to the ALZA ESOP could have reduced the taxable estate by $466,046.25 (50% of the $932,090.50 resale prices), from $1,869,839.03 to $1,403,792.78. *Id.* at ¶ 14. The result would have been a reduction of the federal estate tax from $511,097.55 to $333,735.52. *Id.* Ferman, however, sent the IRS a check for $511,097.55, in full satisfaction of the federal estate tax reflected on the return, without claiming the deduction available under original Section 2057. *Id.* at ¶ 13. The IRS accepted the federal estate tax return through the issuance of the usual "Estate Tax Closing Letter." Subsequently, on December 15, 1987, Ferman filed a claim for a refund in the amount of $177,362.03 – the difference between $511,097.55 and $333,735.52. This is the amount attributable to the ALZA ESOP transactions authorized by Section 2057 of the TRA. *Id.* at ¶ 14.

The IRS disallowed the estate tax refund claim approximately two years later, on January 31, 1990. *See* App. F, at ¶ 16. Ferman then instituted this proceeding against the United States of America ("United States") in the United States District Court for the Eastern District of Louisiana, seeking a refund of federal estate taxes in the amount of $177,362.03, together with interest and attorneys' fees as provided by law. R.Vol. 1, at 290-312; App. F, at ¶ 20.

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the ALZA ESOP to the Estate was [sic] $932,092.50, resulting in an aggregate discount as follows:

Transaction Date	Total Cost	ESOP Transaction	Discount
2/20/87	$348,960.00	$329,175.00	$17,325.00
2/23/87	$329,090.00	$310,317.50	$16,332.50
2/24/87	$310,100.00	$292,600.00	$15,400.00
TOTAL	$988,150.00	$932,090.50	$49,057.50

In her complaint, Ferman alleged that on the transaction dates she fully complied with the plain meaning of Section 2057 and that retroactive application of the 1987 amendment of Section 2057 would be unconstitutional under the Due Process Clause of the Fifth Amendment of the United States Constitution – a violation of her right to predict the consequences of her actions under the plain meaning of the statute. R.Vol. 1, at 290-95. After minimal discovery, the parties agreed to resolve the matter by cross motions for summary judgment. Both sides filed a joint stipulation of facts, see App. F, a motion for summary judgment, a supporting memorandum, and an opposition memorandum. R.Vol. 2, at 114, 139, 172, 188.

Following argument on the motions, the district court entered judgment in favor of the United States, dismissing Ferman's complaint with prejudice. R.Vol. 2, at 375. In doing so, however, the district court stated:

> The court sympathizes with and is instinctively inclined towards the position advocated by the plaintiff (*i.e.*, Ferman). It seems fundamentally wrong for federal taxing authorities to be permitted a retroactive application of a tax in the face of the clear and unambiguous language of a statute.
>
> * * *
>
> [G]ranting . . . amendments retroactive effect in such a way as to adversely affect completed conduct by a citizen smacks of totalitarianism through taxation. It seems fundamentally wrong for Congress to be permitted to make any of its pronouncements retroactive to the detriment of even one citizen for even one moment.
>
> Such circumstance, however, seems to be the law and, while this court disagrees with it, it is nonetheless bound by it. It is therefore with duty-bound distaste that the court finds the

> Government's motion for summary judgment must be granted and the plaintiff's motion denied.
>
> In all candor, the court . . . sincerely hopes that should its judgment be appealed, the court (or courts) above will find error in this ruling.
>
> App. B, at 17.

The district court subsequently entered an amended judgment to reflect Ferman's right to treat the attorneys' fees and expenses reasonably incurred in the prosecution of this action as an administrative expense and thus to deduct them in calculating the federal estate tax. R.Vol. 2, at 319. Ferman filed a notice of appeal from that portion of the final judgment granting relief in favor of the United States and dismissing her claim with prejudice. R.Vol. 2, at 316-17. The Fifth Circuit affirmed the judgment on June 18, 1993, and thereafter denied petitioner's application for rehearing by order dated July 15, 1993.

II. REASONS FOR GRANTING THE WRIT

The denial of Ferman's refund claim raises important questions about the scope of protection the Due Process Clause affords citizens against the retroactive application of estate and gift tax legislation and the right of predictability as a basic element of fairness. This Court, in a series of cases dating back nearly half a century, has extended substantial protection to citizens in this context. The lower courts' rulings in this case conflict with those decisions and, if permitted to stand, would deprive taxpayers of their constitutional right to due process, eliminate predictability, and erode confidence in the rule of law.

As Justice Story accurately observed more than a century ago: "Retrospective laws are . . . generally unjust; [they] neither accord with sound legislation nor with the

fundamental principles of the social compact." 2 J. Story, *Commentaries on the Constitution of the United States*, § 1398 (5th ed. 1891). The problem with such laws is that they "can deprive citizens of legitimate expectations and upset settled transactions." *General Motors Corp. v. Romein*, 112 S. Ct. 1105, 1112 (1992). For this reason, this Court repeatedly has declared that "retroactive legislation [must] meet a burden not faced by legislation that has only future effects. . . . [Although both] [t]he retroactive aspects of legislation, as well as the prospective aspects, must meet the test of due process, . . . the justifications for the latter may not suffice for the former." *United States v. Sperry Corp.*, 493 U.S. 52, 61 (1989) (*quoting Pension Benefit Guar. Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 730 (1984)).

To determine whether a retroactive tax law violates due process, this Court asks whether "retroactive application [of the law would be] so harsh and oppressive as to transgress the constitutional limitation." *Welch v. Henry*, 305 U.S. 134, 147 (1938); *accord United States v. Darusmont*, 449 U.S. 292, 299 (1981) (per curiam). The answer is to be found by examining "the nature of the tax and the circumstances in which it is laid." *Welch*, 305 U.S. at 147; *accord United States v. Hemme*, 476 U.S. 558, 568-69 (1986).[3]

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[3] On occasion, in both tax cases and non-tax cases, this Court has stated that the retroactive application of a statute violates due process only if the result is "arbitrary and irrational" or "arbitrary and capricious." *E.g., Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15 (1976); *Nichols v. Coolidge*, 274 U.S. 531, 542 (1927). Recently, however, the Court has acknowledged that the "harsh and oppressive" standard "does not differ from the prohibition against arbitrary and irrational legislation[.]" *Pension Benefit*, 467 U.S. at 733.

Applying these criteria, this Court long has held that the Due Process Clause prohibits Congress from applying gift and estate tax legislation retroactively to irrevocable transfers made before the legislation was introduced or signed into law. In *Nichols v. Coolidge*, 274 U.S. 531 (1927), for example, the Court held a retroactive application of the federal estate tax unconstitutional. There, the decedent transferred property to a trust in 1907, retained a life estate in the income from the trust, and specified that upon her death the corpus was to go to her children or their representatives. In 1919, Congress enacted legislation that imposed an estate tax on all transfers of property made prior to death that were "intended to take effect in possession or enjoyment at or after . . . death," whether or not the transfer was made before the legislation was passed. *Id.* at 537 (citation omitted). When the decedent died two years later, in 1921, the IRS sought to include the trust corpus in her estate, even though she had no reason to anticipate this result when she originally created the trust in 1907. The Court held that the IRS' conduct was unconstitutional, stating that the retroactive application of the 1919 legislation was "so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment." *Id.* at 542.

Immediately after deciding *Nichols*, this Court held, in *Blodgett v. Holden*, 275 U.S. 142 (1927), that retroactive application of the first federal gift tax violated the Due Process Clause. The petitioner in *Blodgett* had made gifts approximately one month before any gift tax legislation was introduced in Congress. In rejecting the IRS' efforts to apply the statute retroactively, the Court declared:

> As to the gifts which Blodgett made during January, 1924 [before introduction on February

> 25 or enactment on June 2], we think the challenged enactment is arbitrary and for that reason invalid. It seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gift should thereafter be required to pay a charge for so doing.
>
> *Id.* at 147.

In his concurring opinion, Justice Holmes intimated that a retroactive tax in this context would be intolerable because it would " 'impose an unexpected liability that if known might have induced those concerned to avoid it and to use their money in other ways.' " *Id.* at 149 (Holmes, J., concurring) (quoting *Lewellyn v. Frick*, 268 U.S. 238, 251-52 (1925)).

Later in the same term, in *Untermyer v. Anderson*, 276 U.S. 440 (1928), the Court considered the constitutionality of applying the federal gift tax legislation retroactively in a slightly different context. The gift in *Untermyer* was made *after* Congress had begun to consider estate tax legislation but *before* the legislation was enacted. Even so, the Court found that retroactive application of the statute offended due process, declaring:

> The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage of progress through Congress we think is not enough to differentiate this cause from [*Blodgett*] and to relieve the legislation of the arbitrary character there ascribed to it. . . . The taxpayer may justly demand to know when and how he becomes liable for taxes – he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain.
>
> *Id.* at 445-46.

In the next two major cases, *Welch v. Henry*, 305 U.S. 134 (1938), and *United States v. Darusmont*, 449 U.S. 292 (1981) (per curiam), although this Court rejected the taxpayers' due process challenges, the Court did so because the retroactive legislation at issue involved income taxes rather than estate or gift taxes. The different results stemmed from the fact that the "nature of the tax[es] and the circumstances in which [they were] laid" were different. The different results stemmed, in other words, not from a change in the standard applied under the Due Process Clause, but rather from a rigorous application of that standard. As Professor Charles Hochman has explained:

> The justification for upholding retroactive income taxation does not apply to estate and gift taxes, since with respect to these taxes it cannot be assumed that the taxpayer would have disposed of his property in the same manner had he known that it would be subject to the tax.
>
> "The Supreme Court and the Constitutionality of Retroactive Legislation," 73 Harv. L. Rev. 692, 707 (1960) [hereinafter cited as "Retroactive Legislation"].

In *Welch*, the challenged statute retroactively imposed a tax on dividend income that formerly had been excluded from taxation. The taxpayer had not incurred any extra expenses or in any other way changed his conduct in reliance on the prior law. In rejecting the taxpayer's due process challenge, the Court distinguished the tax at issue from a gift tax and held that "a tax on the receipt of income is not comparable to a gift tax. We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one." 305 U.S. at 148. The Court noted

that the result very likely would have been different if the tax had been imposed on a transaction or transfer that was "completely vested before the enactment of the taxing statute." *Id.* at 147. In such a case, which typically involves an *inter vivos* or testamentary gift:

> The nature or amount of the tax [could] not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event. Since, in each [such case], the donor might freely have chosen to give or not to give, the taxation, after the choice was made of the gift which he might well have refrained from making had he anticipated the tax, was thought to be so arbitrary and oppressive as to be a denial of due process.
>
> *Id.* (citations omitted).

In *Darusmont*, the taxpayer challenged the retroactive application of an increase in the minimum tax to a sale of real property he had already completed. After thoroughly analyzing the circumstances surrounding the sale and the imposition of the tax, the Court rejected the taxpayer's due process challenge for two principal reasons. First, the taxpayer had not reasonably relied to his detriment on the prior law. In fact, far from relying on the prior law at all, the taxpayer "conceded . . . , that when he was considering the various ways in which he could dispose of [his] property, he was not [even] aware of the existence of the minimum tax." 449 U.S. at 295. Second, the taxpayer was "hardly in a position to claim surprise at the . . . amendments to the minimum tax. The proposed increase in rate had been under public discussion [in Congress] for almost a year *before* its enactment." *Id.* at 299 (emphasis added).

This Court's recent decision in *United States v. Hemme*, 476 U.S. 558 (1986), likewise turned on "the

nature of the tax and the circumstances in which it [was] laid." In rejecting the taxpayer's due process challenge, the Court put great weight not only on the timing of the transactions but also on the fact that the taxpayer was "no worse off than [he] would have been without the enactment of the Act." *Id.* at 570. In *Hemme*, the Court addressed a controversy arising out of the unification of the estate and gift tax laws in 1976. The 1976 legislation replaced the separate exemptions for each tax with a unified credit that applied to both. *Hemme* involved a transition rule intended to prevent taxpayers from exploiting the change between the date the Conference Committee approved the bill and its effective date. The taxpayer made the gifts in question less than one week before the President signed the bill but three weeks *after* the Conference Committee had approved it. The Court explained that one of the key considerations in ruling on the constitutionality of a retroactive tax "is whether, *without notice*, a statute gives a different and more oppressive legal effect to conduct undertaken before enactment of the statute." *Id.* at 569 (emphasis added). The Court then observed that, even under the retroactive operation of the transitional rule, the taxpayer "still [has] paid estate taxes of $655.16 *less* than [he] would have paid had the 1976 Act never been passed" and, thus, "the retroactive aspect of the law could not be said to be oppressive or inequitable." *Id.* at 571.

The Ninth Circuit recently analyzed all of these cases in *Carlton v. United States*, 972 F.2d 1051 (9th Cir. 1992), *cert. granted*, 61 U.S.L.W. 3854 (U.S. Oct. 4, 1993); App. C, and concluded that they required it to uphold a constitutional challenge to the retroactive amendment of

original Section 2057.[4] The Ninth Circuit identified the guiding principles it gleaned from *Nichols* through *Hemme* as follows:

> From these cases, two circumstances emerge as of paramount importance in determining whether the retroactive application of a tax is unduly harsh and oppressive. First, did the taxpayer have actual or constructive notice that the tax statute would be retroactively amended? Second, did the taxpayer rely to his detriment on the pre-amendment tax statute, and was such reliance reasonable?
>
> App. C, at 17-18.[5]

The taxpayer in *Carlton* was an executor who had sold MCI stock to the MCI ESOP at a discount after the effective date of the TRA but before either the IRS issued Notice 87-13 or Congress introduced the retroactive amendment. The Ninth Circuit readily concluded that the taxpayer had no actual or constructive notice, at the time he executed the transactions, that Section 2057 might be retroactively amended. Since nothing in the statute itself

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[4] A comprehensive analysis of the relevant Supreme Court cases appears in the superb Note, "Has Due Process Struck Out? The Judicial Rubberstamping of Retroactive Economic Laws," 42 Duke L. J. 1068 (1993).

[5] In the petition the United States filed in this Court in *Carlton*, the Solicitor General criticizes the Ninth Circuit for allegedly ignoring the fact that this Court has eliminated claims for substantive due process that pertain to economic and tax legislation. *See* Petitioner's Brief, at 11-12, in Docket No. 92-1941. *Carlton* and *Ferman*, however, are not about substantive due process. They are about procedural due process. They are about the kind of notice, if any, the government must give citizens before it may retroactively require them to suffer an economic loss for executing transactions that the government itself, through a clear and unambiguous statute, encouraged them to execute.

or in any other legislative history suggested in any way that Congress had intended to include a decedent ownership requirement in the statute, "no act of the executive or legislative branch would have given any forewarning of the 1987 amendment at the time the MCI ESOP transaction occurred." App. C, at 18.

The Ninth Circuit further found in *Carlton* that the taxpayer had reasonably relied to his detriment on the plain meaning of original Section 2057. The Court considered both the reason for and the upshot of the taxpayer's reliance to be especially important: "The very fact that Carlton engaged in a costly transaction for no other reason than the inducement provided by the new Section 2057 makes this case significantly different from those rejecting a due process challenge to a retroactively applied revenue law." App. C, at 19-20. The Court then added:

> Indeed, to say that the estate merely "relied" on section 2057 understates the circumstances of this case. The federal government has long sought to promote employee ownership of shares in their employers. Section 2057 was enacted to induce taxpayers to sell shares at a discounted price to an ESOP, thus furthering the public policy of employee ownership. As intended, the Day estate succumbed to the lure and sold shares to the MCI ESOP at a substantial discount. Section 2057 worked. An ESOP was able to buy more shares at a lower price than before. Then, when the private actor had completed the socially desirable action of selling shares at a discount to an ESOP, the government reneged on its end of the deal. It was too late for Carlton to undo his sale to the MCI ESOP. The $631,000 was gone forever, irretrievable.
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> App. C, at 20.

The government in *Carlton* did not challenge Carlton's actual reliance, only its reasonableness:

> The government urges . . . that while Carlton's reliance on the ESOP proceeds deduction is undoubted, it was not reasonable. At the core of this argument is the notion that Section 2057 as originally enacted was such a windfall, any reasonable taxpayer would have known it was "too good to be true." We flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the tax code, but instead must speculate on the unspoken and inchoate intentions of Congress.
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> App. C, at 20.

Moreover, as the Ninth Circuit correctly noted, even if Carlton had been obligated to consider more than just the plain meaning of the statute, the other evidence available to him strongly suggested that Congress intended to do exactly what it did do. For example:

> Carlton had little reason to think Congress had made a drafting error. After all, the ESOP proceeds deduction was not added to the TRA in a frenzied last minute effort. Section 2057 had first been proposed over two and a half years before the TRA was finally passed. As approved by the Senate Finance Committee in March 1984, Section 2057 did not have a decedent ownership requirement. Sen. Comm. on Finance, 98th Cong., 2d Sess., 2 Deficit Reduction Act of 1984, Statutory Language of Provisions Approved by the Committee on March 21, 1984, at 338 (Comm. Print 1984). Thus, it cannot seriously be argued that the decedent ownership requirement was inadvertently omitted in a last minute drafting error.
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> App. C, at 21-22.

Making much the same point, the Ninth Circuit also rightly rejected the government's argument "that the legislative history of the TRA should have put Carlton on constructive notice that Congress had intended to include a decedent ownership requirement in Section 2057, and that an amendment imposing such a requirement was surely in the offing." App. C, at 19. The court accurately described this evidence as "fleeting" and "ambiguous." *Id.*

Additionally, "viewed in the context of the other huge tax incentives that Congress has created to encourage the development of ESOPs, section 2057 should not have raised any eyebrows, even as first enacted in 1986." App. C, at 20-21. These "huge tax incentives" Congress had previously provided show that a taxpayer in late 1986 or early 1987 could reasonably believe that, in enacting original Section 2057, Congress intended to do exactly what it did do. *See* App. G (describing just a few of the substantial benefits Congress had provided).

Carlton recognizes that the Due Process Clause guarantees every citizen the right to predict the consequences of his or her conduct under the plain meaning of a statute. Because it guarantees every citizen this right, the Due Process Clause forbids Congress from retroactively applying an estate tax law to a citizen who relied to his detriment on the prior law and who, at the time he did so, lacked reasonable notice that the law would be changed and that the new law would be applied to him retroactively.

The lower courts in this case reached a different conclusion – and ruled against the taxpayer – for two reasons. *See* App. A; App. B. Neither reason, however, is sound. In fact, both reasons clearly conflict with the

dictates of the Due Process Clause. Neither ruling, moreover, can be reconciled with this Court's decisions from *Nichols* through *Hemme*.

The first error the lower courts here made was adopting a very restrictive reading of the applicable jurisprudence. Both courts, in contrast to the Ninth Circuit in *Carlton*, sought to "limit[] *Nichols*, *Blodgett*, and *Untermyer* to their facts," argued that the outcome in subsequent Supreme Court cases turned on "the distinction between a retroactive change in existing tax law and the retroactive imposition of a wholly new tax," and rejected Ferman's challenge because the retroactive amendment of Section 2057 "cannot be characterized as a retroactive imposition of a wholly new tax." *See* App. A, at 13 n.7, 14; *see also* App. B, at 14. This argument is based on a misreading of *Welch*, *Darusmont*, and *Hemme*. As the Ninth Circuit correctly noted in *Carlton*, in flatly rejecting the same argument:

> [W]e . . . reject the notion of a per se rule that tax statutes can *always* be retroactively applied so long as they do not enact a "wholly new" tax. The Supreme Court's two most recent decisions regarding retroactive challenges to tax statutes, *Hemme* and *Darusmont*, did not involve wholly new taxes. Despite that fact, the Court engaged in a thorough analysis of the circumstances of each retroactive application before making its determination of constitutionality. This clearly indicates that retroactive application of the tax laws is not "automatically" permitted so long as a wholly new tax is not involved.
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> App. C, at 11 (emphasis in original).[6]

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[6] This Court's decision in *Pension Benefit Guaranty Corp. v. R.A. Gary & Co.*, 467 U.S. 717 (1984), which preceded *Hemme*,

No principled basis exists, moreover, for having the outcome of due process challenges to retroactive gift and estate tax laws turn on the distinction between a retroactive change in an existing tax law and the retroactive imposition of a wholly new tax. The justification for extending constitutional protection to the taxpayers in *Nichols* and *Blodgett*, for example, who had no opportunity to rescind the *inter vivos* gifts they made before Congress enacted the first gift and estate tax laws, is that retroactively taxing the gifts in those circumstances – the "circumstances in which [they were] laid" – would be "harsh and oppressive." The same justification applies to Carlton and Ferman. Indeed, the justification for extending constitutional protection to them is even greater since Congress specifically induced them to act and then "reneged on its end of the deal." Never before has the government enacted a deduction to induce and invite private conduct to promote public goals and then sought to deny the benefit of the deduction retroactively to a taxpayer who had relied on the statute to her detriment. It is "a simple constitutional principle" that, when government induces reliance, "government must keep its word." Laurence H. Tribe, *American Constutitional Law*, 619 (2d ed. 1988).[7]

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does not suggest otherwise. In *Pension Benefit*, the company asserting the due process challenge had adequate notice that the law would be applied retroactively to it since, before it acted, Congress had introduced new legislation to change the law and, as in *Darusmont*, "the various legislative proposals debated by Congress before enactment of the [statute] uniformly included retroactive effective dates among their provisions." *Id.* at 732.

[7] *See also Eli Lilly & Co. v. Commissioner*, 856 F.2d 855, 862 (7th Cir. 1988) (Commissioner lacked authority to override nonrecognition tax treatment for "conduct that Congress sought to

The Fifth Circuit's other error was rejecting Ferman's due process challenge on the ground that "Notice 87-13 reasonably forewarned [her] and her attorneys of Congress' amendment to Section 2057." App. A, at 17.[8] The clear and unambiguous language in original Section 2057 authorized Ferman to execute the transactions she made in February 1987 and to receive the deductions she is seeking in these proceedings. *See* App. D. Since the pertinent part of Notice 87-13 conflicts with this language, Ferman was entitled to ignore Notice 87-13 and to rely instead on the clear and unambiguous language chosen by Congress, which is the only body the Constitution vests with authority to legislate regarding taxes and which never expressed a contrary view until after Ferman had acted – until it was too late, that is, for Ferman to rescind the sales and recover the estate's $49,057.50 loss.

Notice 87-13 may not be invoked as a basis for denying Ferman's refund claim for several reasons. To begin, Notice 87-13 cannot be reconciled with the "plain meaning" rule. In determining the meaning of a statute, courts are to "look first to its language . . . , giving the 'words used' their 'ordinary meaning.' " *Moskal v. United States*,

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encourage[.]"); *Le Croy Research Sys. Corp. v. Commissioner*, 751 F.2d 123, 127 (2nd Cir. 1984) ("[I]t is clear that there are judicially enforceable limits on the Commissioner's discretion to ignore prior assurances given to taxpayers."); *City of Anaheim v. FERC*, 723 F.2d 656, 659 (9th Cir. 1984) ("[A]gencies may not impose undue hardship by suddenly changing direction, to the detriment of those who have relied on past policy.").

[8] Without analyzing the issue, the Ninth Circuit in *dicta* in *Carlton* distinguished *Ferman* on the same ground. App. C, at 25. As explained in the text, however, the Ninth Circuit was wrong for the same reason the Fifth Circuit was wrong. It is axiomatic, moreover, that a decision is not authority for a proposition a court did not decide or need to decide.

498 U.S. 103, 108 (1990) (citing *Richards v. United States*, 369 U.S. 1, 9 (1962)). "[W]here . . . th[e] statute's language is plain, 'the sole function of the courts is to enforce it according to its terms.' " *United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 241 (1989) (quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917)); *see also Adams Fruit Co. v. Barrett*, 494 U.S. 638, 644 (1990) ("As a general rule of statutory construction, where the terms of a statute are unambiguous, judicial inquiry is complete.").

The same rule applies with equal force to a federal agency's interpretation of a clear and unambiguous statute. An agency rule or notice may not serve to amend a statute, *Koshland v. Helvering*, 298 U.S. 441, 447 (1936), or to add to it "something which is not there." *United States v. Calamaro*, 354 U.S. 351, 359 (1957). In every case, "[i]f the statute is clear and unambiguous 'that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.' . . . The traditional deference courts pay to agency interpretation is not to be applied to alter the clearly expressed intent of Congress." *K Mart Corp. v. Cartier, Inc.*, 486 U.S. 281, 291 (1988) (citations omitted); *see also Sullivan v. Everhart*, 494 U.S. 83, 88 (1990) (same).

Indeed, any attempt by an agency to vary the terms of a clear and unambiguous statute results in a nullity. As this Court declared in *Manhattan General Equipment Co. v. Commissioner*, 297 U.S. 129 (1936):

> The power of an administrative officer . . . to administer federal statutes and to prescribe rules and regulations . . . is not the power to make law . . . but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule

> out of harmony with the statute, is a *mere nullity*.
>
> *Id.* at 134 (emphasis added).

Accord United States v. Larionoff, 431 U.S. 864, 873 n.12 (1977) (same); *see also United States v. Vogel Fertilizer Co.*, 455 U.S. 16, 22 (1982) (same result regarding IRS' interpretation of "controlled group of corporations"); *Rowan Cos. v. United States*, 452 U.S. 247, 260 (1981) (same result regarding IRS' interpretation of "wages"). *See generally* Michael I. Saltzman, *IRS Practice and Procedure*, 3-9, 3-11 (2d ed. 1991).[9]

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[9] Previously, the United States has essentially ignored the application of the "plain meaning" rule to the completed transactions that constitute the basis of Ferman's refund claim and relied instead primarily upon a so-called "legislative history" based on comments made in Congress, not during the debates over the TRA, but during the subsequent debates following the introduction of the OBRA legislation in 1987. This attempt to construct a prior, unstated Congressional intent for original Section 2057 cannot override the clear and unambiguous language of that provision. *American Tobacco Co. v. Patterson*, 456 U.S 63, 68 (1982) ("[T]he legislative purpose is expressed by the ordinary meaning of the words used." (quoting *Richards v. United States*, 369 U.S. 1, 9 (1962))). As the Supreme Court declared in *Union Bank v. Wolas*, 112 S. Ct. 527 (1992), it is

> regrettable that we have a legal culture in which [legislative history and policy] arguments have to be addressed.... Since there was here no contention of a "scrivener's error" producing an absurd result, the plain text of the statute should have made this litigation unnecessary and unmaintainable.
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> *Id.* at 534.

Indeed, the mere attempt to construct a prior unstated Congressional intent "calls into question whether . . . it any longer makes sense to talk of 'a government of laws, not of men' " *Patterson v. Shumate*, 112 S. Ct. 2242, 2250-51 (1992).

In light of the "plain meaning" rule and the prohibition against federal agencies ignoring it, Notice 87-13 was an absolute nullity and Ferman was entitled to treat it as such.[10] There can be no doubt that the Notice conflicted with the plain meaning of Section 2057 of the TRA. The government itself expressly conceded as much in *Carlton*:

> The government concedes that the decedent ownership requirement announced in Notice 87-13 was not contained in section 2057 as originally enacted in 1986, was not contained in any amendments to the TRA passed before the 99th Congress adjourned, nor was it in any of the

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The principal rational for introducing the OBRA legislation retroactively amending Section 2057 was offered by Senator Bentsen, who asserted that the Conference Committee's original estimate in 1986 of the cost was mistaken and that the mistake would result in a projected tax loss significantly higher than originally anticipated. The purported tax losses Senator Bentsen referred to, however, are not reflected in the legislation, and no showing of significant loss of revenue to the United States has yet been produced. The projections, moreover, pertained to the entire potential loss, whereas the only loss that is relevant here is the potential loss for the period between October 22, 1986 and February 26, 1987 – the period between the effective date of original Section 2057 and the date the proposed 1987 amendment was introduced.

[10] This view is reinforced by the "hornbook law that informal [IRS] publications all the way up to revenue rulings are simply guides to taxpayers, and a taxpayer relies on them at his peril." *Caterpillar Tractor Co. v. United States*, 589 F.2d 1040, 1043 (Ct. Cl. 1978). If neither Congress nor the IRS is bound by a valid notice, due process dictates that a taxpayer not be bound by a notice that is an absolute nullity. Due process dictates, in other words, that a taxpayer be allowed to ignore a null notice and to rely instead on a clear Congressional statute. Put another way, *Carlton* recognizes that, under the Due Process Clause, Congress and the IRS should be bound by the tax laws they have written to the same extent those laws bind taxpayers.

proposed technical and clerical amendments to the TRA considered by the 99th Congress.

App. C, at 5-6.

Significantly, moreover, immediately after the IRS issued the Notice, the Assistant Secretary of the Treasury for Tax Policy publicly "questioned the legality" of the Notice and stated unequivocally that "[t]here is no legislative history to support it." *See* Daily Tax Report (BNA), at G-1 (Jan. 29, 1987). The lack of legislative authorization requires that this Court either ignore Notice 87-13 or treat it as an illicit attempt to legislate – an absolute nullity – and proceed to apply Section 2057 of the TRA under the "plain meaning" rule.[11]

In arguing to the contrary, the Commissioner of Internal Revenue has sought to arrogate to his office the right

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[11] The Fifth Circuit's reliance on *Milliken v. United States*, 283 U.S. 15, 23-24 (1931), is misplaced. *Milliken* upheld a retroactive tax rate increase on a gift made in contemplation of death, because such gifts were already subject to tax "of which the donor was forewarned at the time he elected to exercise the privilege" to give. The Court later referred to the taxpayer in *Milliken* as "forewarned by the statute books." *Welch v. Henry*, 305 U.S. 134, 147 (1938). The facts and holding in *Milliken* are inapposite to this controversy. Milliken made a gift and reserved a life estate expecting it to be taxed; although his expectations may have been disappointed to the extent the rate of tax increased, neither his gift nor his reservation of the life estate was induced by a specific promise of a tax saving. Here, by contrast, Ferman was specifically encouraged to sell employer stock to an ESOP by the unqualified promise of an estate tax deduction, and she did so at a substantial discount from the prevailing market price. By selling at a discount, she, in effect, shared the anticipated tax benefit with the ESOP participants. When Congress attempted to change the law, it deprived her not only of the tax benefits she fully and reasonably expected, but also of the portion of the benefit that she had irrevocably shared with the ALZA employees.

to create and impose legislation in clear contravention of Article I, Sections 1 and 8 of the Constitution of the United States. Article I, Section 1 of the United States Constitution vests all legislative powers in the Congress:

ARTICLE I

> **Section 1. All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.**

Section 8 vests in the Congress – and only in the Congress – the power to legislate with respect to taxes:

> **Section 8. The Congress shall have Power to lay and collect Taxes, Duties, Imposts and Excises. . . .**

Thus, the legislative power to tax is vested solely in the Congress and, absent Congressional authorization, may not be exercised by the Secretary of the Treasury or the Commissioner of Internal Revenue through announcements or notices. Any attempt by the IRS or the Treasury Department to legislate through comments or notices regarding taxes is unconstitutional.

Finally, in deciding what to do, Ferman was entitled to rely on the clear and unambiguous language of original Section 2057 because the modern cases involving retroactive estate and gift taxes permit a court to infer adequate notice of an intent to amend only from a pending bill; the cases do not permit retroactive application prior to the time the amending legislation was introduced in Congress. *See, e.g., Estate of Ekins v. Commissioner*, 797 F.2d 481 (7th Cir. 1986) (1978 amendment under consideration by Congress three months prior to transfer); *Reed v. United States*, 743 F.2d 481, 486 n.4 (7th Cir. 1984), *cert. denied*, 471 U.S. 1135 (1985) (involving same legislation); *Fein v. United States*, 730 F.2d 1211 (8th Cir.), *cert. denied*,

469 U.S. 858 (1984) (same legislation); *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir.), *cert. denied*, 462 U.S. 1120 (1983) (same legislation); *cf. United States v. Hemme*, 476 U.S. 558, 562-63 (1986) (retroactive application permitted to gift made after Conference Committee Report but before presidential signature).

The only exception to this rule appears in three income tax cases, all of which involve a formal pronouncement by the President of the United States to Congress. Two of the cases involve the same facts: On July 18, 1963, President Kennedy delivered a formal message to both houses of Congress proposing an interest equalization tax to alleviate the nation's balance of payments problem by restricting long-term capital outflow from the United States. In his message, President Kennedy proposed that the tax be made retroactive to the date of his message lest a rush to purchase foreign securities in the interim between proposal and enactment produce just the opposite of the intended result. Congress complied, and the Interest Equalization Tax Act of 1964 ("1964 Act") was signed into law on September 2, 1964; its provisions were made retroactive to July 18, 1963. *First Nat'l Bank v. United States*, 420 F.2d 725, 726-27 (Ct. Cl.), *cert. denied*, 398 U.S. 950 (1970).

Taxpayers who bought foreign stocks between the date of introduction of the 1964 Act and its enactment challenged the retroactive feature of the legislation on due process grounds. In rejecting the challenges, the courts held that the Presidential message and other widespread publicity surrounding the introduction of the bill had given the taxpayers reasonable cause to believe their transactions would be taxed. *First Nat'l Bank*, 420 F.2d at 730; *Purvis v. United States*, 501 F.2d 311 (9th Cir. 1974),

cert. denied, 420 U.S. 947 (1975); *see also Sidney v. Commissioner*, 273 F.2d 928, 932 (2d Cir. 1960) (late 1950 amendment permissibly applied retroactively to January 30, 1950 transaction; notice found in January 25, 1950 presidential message to Congress announcing amending legislation).

Ferman has found no case other than these that treat an executive branch pronouncement as the constitutional equivalent of statutory notice of retroactive taxation. These three cases, moreover, are all income tax cases, in which retroactivity is more generously accepted, *see, e.g., Welch v. Henry*, 305 U.S. 134 (1938), and all involve a formal proposal by the President to Congress, with all of its accompanying publicity. Here, the government seeks, and the lower courts have recognized, a very substantial extension of this rare exception. They would extend it to apply to an informal press release of the IRS that cannot be reconciled with the plain meaning of a Congressional statute. The Due Process Clause forbids such an extension.

In essence, this Court's test for determining the constitutionality of gift and estate taxes "is whether a party has changed his position in reliance upon the existing law, or whether the retrospective act gives effect to or defeats the reasonable expectations of the parties." "Retroactive Legislation," at 696. This test requires rules and procedures that ensure predictability. It requires that the government give citizens adequate notice of what they may and may not do under the law. Pursuant to this test, an estate tax may be applied retroactively to a transaction only if the citizen who participated in the transaction had reasonable notice at the time she did so that the law would be applied retroactively to it. An IRS notice that is criticized by the Assistant Secretary of the Treasury for

Tax Policy as being of "question[able] legality," that conflicts with the clear and unambiguous language of a statute, that has no support in the legislative history, and that is therefore an absolute nullity does not provide the type of notice the Due Process Clause requires.

III. CONCLUSION

Congress invited Ferman's transactions in 1987 to benefit employees and ESOPs. Those transactions produced the expected benefits and were complete and irreversible when Congress introduced the amending legislation. Due process requires that Ferman's justifiable expectations be fulfilled. This Court should therefore reverse.

Respectfully submitted,

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APPENDIX A

Bertha Paglin FERMAN, etc.,
Plaintiff-Appellant,

v.

UNITED STATES of America,
Defendant-Appellee.

No. 92-3482.

United States Court of Appeals,
Fifth Circuit.

June 18, 1993.

Taxpayer brought suit to obtain refund of federal estate taxes. The United States District Court for the Eastern District of Louisiana, George Arceneaux, Jr., J., 790 F.Supp. 656, granted summary judgment in favor of government, and taxpayer appealed. The Court of Appeals, King, Circuit Judge, held that amendment to Internal Revenue Code, which retroactively restricted availability of state tax deduction for sale of employer securities to employee stock ownership plan, did not violate due process.

Affirmed.

Paul O.H. Pigman, Jack M. Weiss, George C. Freeman, III, Dorothy H. Wimberly, Stone, Pigman, Walther, Wittmann & Hutchinson, New Orleans, LA, Irving Ferman, Washington, DC, for plaintiff-appellant.

David W. Hettig, Palo Alto, CA, Charles C. Marson, San Francisco, CA for amici-morici, et al.

Gary Allen, Chief, Teresa E. McLaughlin, Gilbert S. Rothenberg, Appellate Section, Tax Div., Justice Dept., Washington, DC, for defendant-appellee.

Appeals from the United States District Court for the Eastern District of Louisiana.

Before KING and EMILIO M. GARZA, Circuit Judges, and HALL,* District Judge.

KING, Circuit Judge:

Bertha Paglin Ferman, acting in her capacity as executrix of the estate of Jules J. Paglin, brought this action against the United States to obtain a refund of $117,362.03 in federal estate taxes, plus interest and costs. Ferman asserts that an amendment to the Internal Revenue Code, which retroactively restricted the availability of an estate tax deduction for the sale of employer securities to an employee stock ownership plan, violates due process as applied to Paglin's estate. The parties filed cross-motions for summary judgment before the district court, which granted summary judgment in favor of the government. Ferman appeals from that judgment. Finding that, in the context of the facts before us, the retroactive amendment to the deduction at issue does not constitute a violation of due process, we affirm the district court's grant of summary judgment in favor of the government.

I. BACKGROUND

The facts in the case before us are not in dispute, and they have been presented by the court below. *See Ferman v. United States*, 790 F.Supp. 656 (E.D.La.1992). The following is a brief discussion of (a) section 2057 of Title 26 and

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* District Judge of the Eastern District of Texas, sitting by designation.

its amendment, (b) the facts relevant to this appeal, and (c) the proceedings below.

A. *Section 2057*

The Tax Reform Act of 1986, Pub.L. No. 99-514, 100 Stat. 2085 (the Act), was enacted on October 22, 1986. Section 1172(a) of the Act added section 2057 to the Internal Revenue Code, which allowed estates a deduction for fifty percent of the "qualified proceeds" of a "qualified sale" of any employer securities to an employee stock ownership plan (ESOP). *See* 26 U.S.C. § 2057. The term "qualified sale" was defined as "any sale of employer securities by the executor of an estate to . . . an employee stock ownership plan . . . described in section 4975(e)(7)." 26 U.S.C. § 2057(b)(1). "Qualified proceeds" was defined as "the amount received by the estate from the sale of employer securities at any time before the date on which the return of the tax imposed by section 2001 is required to be filed." 26 U.S.C. § 2057(c)(1). Under section 1172(c) of the Act, section 2057 was made applicable to sales by executors required to file estate tax returns after the date of its enactment. As discussed below, section 2057 made it possible for the executor of an estate to purchase stock from a company and then resell that stock to the company's ESOP – usually at a discount so as to provide an incentive for the ESOP to participate in the transaction – in order to receive a fifty percent deduction on the proceeds of that sale.

On January 5, 1987, the Internal Revenue Service (IRS) issued a news release addressing a number of statutory changes affecting employee plans. This notice was formally published on January 25, 1987 as Notice 87-13, 1987-1 C.B. 432 (Notice 87-13). "Question-and-answer 23"

of Notice 87-13 indicated that, "[p]ending the enactment of clarifying legislation," the IRS would not recognize the deduction permitted under section 2057 unless (1) the decedent directly owned securities *before death* and (2) the securities were allocated or held for future allocation by the plan in specified ways. *Id.* at 442.

On February 26, 1987, proposed legislation concerning the scope of section 2057's deduction was introduced into Congress. The bill's sponsors stated that it "would confirm the positions taken in IRS Notice 87-13" and that, "[b]ecause these provisions accurately reflect Congressional intent in enacting the provision, this clarification would be effective as if included in the [1986 Act]." 133 CONG.REC. H845 (daily ed. Feb. 27, 1987); 133 CONG.REC. S2532 (daily ed. Feb. 27, 1987). This proposal made its way into the Omnibus Reconciliation Act of 1987, Pub.L. No. 100-185, 101 Stat. 1330 (the 1987 Act), which was enacted into law on December 22, 1987. Section 10411 of this Act amended section 2057 of the Internal Revenue Code to impose the additional requirements identified in Notice 87-13, effective as if the provision had been contained in the 1986 Act.[1] The legislative history behind the enactment of the 1987 Act states, in pertinent part,

> [i]n enacting the estate tax deduction[,] Congress intended that it would be utilized in a limited number of transactions with a relatively modest revenue loss. As drafted, the estate tax

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[1] Although not important for the purposes of resolving the case before us, we note that section 2057 was subsequently repealed for the estates of persons dying after July 12, 1989. *See* Omnibus Budget Reconciliation Act of 1989, Pub.L. No. 101-239, 103 Stat. 2106, 2352-2354, § 7304(a).

deduction was significantly broader than what was originally contemplated by Congress in enacting the provision. The committee believes it is necessary to conform the statute to the original intent of Congress in order to prevent a significant revenue loss under the Tax Reform Act of 1986.

While Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction[,] or that the securities acquired in a transaction for which the deduction was claimed need not be allocated to plan participants. The provision would not have been adopted in its present form had the full extent of the revenue impact and the effect of the provision been recognized.

The committee concludes that it is now necessary to modify the provision to bring the revenue loss in line with the original estimate and congressional intent. The modifications contained in the bill are designed to achieve this result while maintaining to the fullest extent possible the incentive to transfer employer securities to ESOPs.

The primary thrust of the bill is to conform the provision to the original intent of Congress in enacting the deduction. In this respect, the bill has two elements.

First, the bill makes clear that the positions taken by the Internal Revenue Service in Notice 87-13 with respect to the estate tax deduction are an accurate statement of Congressional

> intent in enacting the provision. If these clarifications are not made, taxpayers could qualify for the deduction by engaging in essentially sham transactions.
>
> Second, the bill makes additional changes in the deduction which more fully effectuate the intent of Congress to provide limited relief for the estate tax.

H.R.Rep. No. 100-391(II), 100th Cong., 1st Sess. 1045 (1987), *codified at* 4 U.S.C.C.A.N. 2313-1, 2313-661 (1987); *see also* H.R.Conf. Rep. No. 100-495, 100th Cong., 1st Sess. at 998 (1987), *codified at* 4 U.S.C.C.A.N. 2313-1245, 2313-1744 (1987) (adopting the House version of the bill).

B. *The Paglin Estate's Reliance on the Unamended Version of Section 2057*

Bertha Paglin Ferman is the testamentary executrix of the estate of her father, Jules J. Paglin (decedent). At the time of his death on October 27, 1986, the decedent owned stock in over 75 publicly traded corporations, including 100 shares of ALZA Corporation stock valued at $2,031.25; the decedent had no legal relationship with the ALZA ESOP at the time of his death.

From February 20 to February 24, 1987, decedent's estate entered into three series of transactions in which it purchased shares of ALZA Corporation stock, and then sold those shares to the ALZA Corporation ESOP: (1) on February 20, the estate purchased 12,300 shares of stock at a total cost of $348,960, which it sold to the ESOP that same day for $329,175; (2) on February 23, the estate purchased 112,200 shares of ALZA stock for $329,090,

which it sold to the ESOP that same day for $310,317.50; and (3) on February 24, the estate purchased 11,200 shares of ALZA Corporation common stock for $310,100, which it sold to the ESOP that day for $292,600.[2] The parties have stipulated that the $7,000 brokerage commission paid by the estate when originally purchasing the stock and the stock value discounts given to the ESOP resulted in a total loss to the estate of $49,057.50.[3]

Ferman entered these transactions on the advice of her attorneys in order to realize a tax deduction under section 2057, and the parties have stipulated that her "decision to purchase these shares of ALZA stock, pay the commissions due on the purchases, and resell the stock to the ALZA ESOP at a discount, was purely tax motivated." The parties have also stipulated that

> [t]he only reason that the estate purchased ALZA stock, as opposed to the stock of another company, was the fact that the ALZA ESOP had by prior agreement agreed to purchase at a discount the entire quantity of ALZA Corporation stock directly from the estate, and the ALZA ESOP agreed to make the purchase from the estate over the three-day period.

Ferman also chose the ALZA ESOP because it agreed to purchase the shares at a lower discount than the other ESOPs she contacted.

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[2] These stock purchase prices include brokerage commissions paid by the estate and, therefore, they do not reflect the actual market value of the stock.

[3] The record does not disclose whether the estate in any way claimed this loss as a tax deduction.

On December 15, 1987, the estate filed a claim with the IRS for a refund on its federal estate taxes in the amount of $177,362.03, plus interest. According to the estate, it was entitled to a deduction under section 2057 in the amount of $466,046.25, or one-half of the $932,092.50 total proceeds received from its sales of ALZA Corporation stock to the ALZA ESOP. This deduction reduced the decedent's taxable estate from $1,869,839.03 to $1,403,792.78, and the estate's tax liability from $511,097.55 to $333,735.52, for a total savings of $177,362.03. The IRS denied the estate's refund claim on January 31, 1990.

C. *Proceedings*

Soon after the IRS denied the estate's refund, Ferman instituted this action contending that (1) the estate is entitled to the ESOP sales deduction because it fully complied with the plain meaning of section 2057 as it existed at the time the sales were consummated, and (2) retroactive application of the 1987 Act to the estate's circumstances violated the Due Process Clause of the Fifth Amendment. Ferman moved for summary judgment, and the IRS filed a cross-motion for summary judgment, contending that the government's retroactive amendment to section 2057 does not constitute a violation of due process.

The district court granted summary judgment in favor of the IRS, holding that the government's retroactive amendment to section 2057 does not violate the Due

Process Clause. First, the court rejected Ferman's argument that "she could not have foreseen Congress' retroactive amendment of section 2057 because no legislative action took place until after she completed the stock transfers at issue." *Ferman*, 790 F.Supp. at 661. According to the district court, "Notice 87-13 forewarned what the future could and ultimately did bring." *Id.* The court also stated that "[i]t would seem abundantly clear that, given the IRS's position, Congress would enact corrective and retroactive legislation at the earliest possible time." *Id.* The district court also noted that, "[w]hile the net effect of the 1987 amendments to section 2057 clearly denied the Paglin estate the benefits of the fifty percent deduction, such denial did not amount to a 'new tax' as contemplated by the relevant law." *Id.*

Finally, the district court dismissed the estate's reliance upon such cases as *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), and *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206, *modified*, 276 U.S. 594, 48 S.Ct. 105, 72 L.Ed. 206 (1928), where the Supreme Court refused to subject gifts to the gift tax where they were completed before the first gift tax had even been implemented. The district court recognized that, in *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986), the Supreme Court limited *Untermyer* to its facts, specifically stating that *Untermyer* is of questionable value in assessing the constitutionality of amendments that bring about changes in the operation of *existing* tax laws. Accordingly, the district court distinguished *Untermyer* and *Blodgett* from the case before us on the ground that this case "does not involve a new estate tax on intervivos gifts but, rather, a change in the

application of an estate tax deduction." *Id.* at 662. In sum, although the district court stated that, "[i]n all candor, the court, in this instance, sincerely hopes that, should its judgment be appealed, the court (or courts) above will find error in this ruling[,]" it concluded that "it is true beyond peradventure that Congress may surely correct any error or inadvertence it may have created; indeed, Congress is constitutionally able to change and modify our nation's tax laws at will." *Id.* at 662-63.

II. ANALYSIS

The parties have stipulated that (1) the government erred in drafting section 2057 in that it failed to properly estimate the cost to the United States Treasury resulting from the deduction created under this section, (2) the government's statutory power to tax generally includes the discretion to correct such mistakes, and, (3) solely as a result of this deduction, Ferman entered into transactions which, although they benefited the estate under the unamended version of section 2057, were otherwise to the detriment of the estate in the amount of $49,057.50.[4] On appeal, Ferman contends that she reasonably relied upon section 2057 when entering into the transactions at issue between February 20 and February 24, 1987. The government contends that (1) it acted within its taxing authority in applying its 1987 amendment to section 2057 retroactively, for this amendment constitutes an adjustment to

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[4] This amount constitutes the aggregate of (1) the broker's commissions paid by the estate when it purchased the ALZA stock and (2) the discounts given to the ALZA ESOP on the price of the stock.

an existing tax rather than a new tax, and (2) Ferman's reliance on section 2057 was not reasonable in light of (a) Notice 87-113, (b) the legislative history behind section 2057, and (c) the extent of the government's error in drafting section 2057. Accordingly, the issue before us constitutes a question of law: We must determine whether, in the context of the facts before us, the government's retroactive application of its amendment to section 2057 constitutes a violation of due process or a legitimate exercise of the government's statutory power to tax.

The Supreme Court has held that the retroactive application of a tax statute violates the Due Process Clause where the result is "so harsh and oppressive as to transgress the constitutional limitation." *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078, *quoting Welch v. Henry*, 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938).[5] In making such a determination, courts must "consider the nature of the tax and the circumstances in which it is laid. . . . " *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078.

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[5] Ouside of the tax context, the Court has held that the retroactive application of a statute must be "arbitrary and irrational" to violate due process. *See Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15, 96 S.Ct. 2882, 2892, 49 L.Ed.2d 752 (1976). Nevertheless, this difference is actually just one of semantics, for the Court has held that the "harsh and oppressive" impact standard used in the tax context "does not differ from the prohibition against arbitrary and irrational legislation that we clearly enunciated in *Turner Elkhorn*." *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733, 104 S.Ct. 2709, 2720, 81 L.Ed.2d 601 (1984).

In *Welch*, the case in which the Court introduced this "harsh and oppressive" impact standard, a Wisconsin taxpayer challenged the state's imposition of additional taxes arising from a change in the tax rate on corporate dividends received by the taxpayer one and two years earlier. Although it had previously struck down retroactive taxes on gifts,[6] the Court upheld the Wisconsin statute by distinguishing the tax at issue from gift taxes. Specifically, the Court held that

> a tax on the receipt of income is not comparable to a gift tax. We cannot assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one. . . .

305 U.S. at 148, 59 S.Ct. at 126. The Court then went on to place the right to tax income retroactively within the realm of the broad taxing power of legislatures, stating that

> [w]e cannot say that the due process which the Constitution exacts denies that opportunity to legislatures; that it withholds from them, more than in the case of a prospective tax, authority to distribute the increased tax burden in the light of experience and in conformity with accepted notions of the requirements of equal protection; or that in view of well established legislative practice, both state and national, taxpayers can justly assert surprise or complain of arbitrary action in the retroactive apportionment

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[6] *See Untermyer*, 276 U.S. at 440, 48 S.Ct. at 353; *Blodgett*, 275 U.S. at 142, 48 S.Ct. at 105; *Nicholas v. Coolidge*, 274 U.S. 531, 47 S.Ct. 710, 71 L.Ed. 1184 (1927).

> of tax burdens to income at the first opportunity after knowledge of the nature and amount of the income is available.

Id. at 149-150, 59 S.Ct. at 127.

In cases decided subsequently to *Welch* and the *Nichols-Blodgett-Untermyer* trilogy, the Court has drawn a clearer distinction between the retroactive imposition of a wholly new tax and a retroactive change in the base or rate of an existing tax. *See, e.g., Hemme,* 476 U.S. at 568, 106 S.Ct. at 2077; *United States v. Darusmont,* 449 U.S. 292, 299, 101 S.Ct. 549, 553, 66 L.Ed.2d 513 (1981).[7] In *Darusmont,* the Court considered a challenge to the retroactive application of a minimum tax provision which increased

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[7] This court and our sister circuits also have recognized the distinction between a retroactive change in existing tax law and the retroactive imposition of a wholly new tax, thereby limiting *Nichols, Blodgett,* and *Untermyer* to their facts. *See, e.g., Wiggins v. Commissioner,* 904 F.2d 311, 314 (5th Cir.1990) (upholding retroactive exclusion of investment tax credit recapture when calculating an alternative minimum tax); *Estate of Ekins v. Commissioner,* 797 F.2d 481, 484 (7th Cir.1986) (upholding the retroactive repeal of an estate tax exclusion for life insurance policies); *Fein v. United States,* 730 F.2d 1211, 1213 (8th Cir.), *cert. denied,* 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984) (same); *Estate of Ceppi v. Commissioner,* 698 F.2d 17, 21 (1st Cir.1983), *cert. denied,* 462 U.S. 1120, 103 S.Ct. 3088, 77 L.Ed.2d 1350 (1983) (upholding the retroactive repeal of an estate tax exclusion); *Westwick v. Commissioner,* 636 F.2d 291, 292 (10th Cir.1980) (retroactive changes in the minimum tax upheld in spite of detrimental reliance); *First National Bank in Dallas v. United States,* 420 F.2d 725, 730 n. 8, 190 Ct.Cl. 400 (1970) (interest equalization tax on foreign stock acquisitions may be retroactively applied), *cert. denied,* 398 U.S. 950, 90 S.Ct. 1868, 26 L.Ed.2d 289 (1970); *Sidney v. Commissioner,* 273 F.2d 928, 932 (2d Cir.1960) (upholding retroactive taxation of gains realized from collapsible corporations).

the tax due from the sale of a taxpayers' home which had occurred before the provision was enacted. After stating that "[t]he proposed increase in rate had been under public discussion for almost a year before its enactment" and that taxpayers were therefore in no position to claim surprise, the Court held that taxpayers' " 'new tax' argument is answered completely by the fact that the 1976 amendments to the minimum tax did not create a new tax." 449 U.S. at 299-300, 101 S.Ct. at 553. Similarly, in *Hemme*, the trustee of a taxpayer's estate challenged the retroactive application of a transitional rule bridging the gap between new and old regimes for federal taxation of gifts and estates. Applying the "harsh and oppressive" impact standard introduced in *Welch*, the Court "considered the nature of the tax and the circumstances in which it [was] laid. . . . " 476 U.S. at 568-69, 106 S.Ct. at 2078. The Court, without determining whether the provision at issue constituted retroactive taxation, held that "the provision represents a fair judgment by Congress that does not deprive appellees of anything to which they can assert a constitutional right." *Id.* at 571, 106 S.Ct. at 2079.

The change in tax law at issue in the case before us – the retroactive amendment to (and limitation of) a deduction created under the Tax Act of 1986 – cannot be characterized as a retroactive imposition of a wholly new tax. The estate tax was in place before section 2057 was introduced, and the amendment at issue simply limited the deduction provided under 2057, thereby restoring the pre-section 2057 status quo. To determine whether the retroactive amendment of section 2057 constitutes a

change in tax law "so harsh and oppressive as to transgress the constitutional limitation[,]"[8] we must carefully consider the nature of the tax and the facts before us. *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078; *cf. Wiggins*, 904 F.2d at 316 (when retroactive legislation is challenged on due process grounds, a case-by-case analysis is required).[9]

Evaluating the government's retroactive amendment of section 2057 in the context of the facts before us, we conclude that the government did not inflict a "harsh and oppressive" change in tax law upon Paglin's estate. First, Notice 87-13 was formally published on January 25, 1987 – nearly a month *before* Ferman entered into the series of transactions at issue in this case. This fact distinguishes the case before us from the Ninth Circuit's opinion in *Carlton v. United States*, 972 F.2d 1051 (9th Cir.1992). Specifically, although *Carlton* also involved an executor's reliance on section 2057, the executor in that case entered the transaction at issue nearly one month *before* the IRS issued Notice 87-13. In reaching its conclusion that, as applied to Carlton's transaction, Congress' amendment to section 2057 violated the Due Process Clause, the Ninth

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[8] *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078, *quoting Welch*, 305 U.S. at 147, 59 S.Ct. at 125.

[9] In *Wiggins*, this court held that a retroactive amendment establishing an investment tax credit recapture constituted a correction rather than a new tax. 904 F.2d at 314. Specifically, we stated that "[t]he legislative history of the 1984 amendment indicates that this was not a new tax, but a correction necessary to effectuate Congress' intent in enacting [the Tax Equity and Fiscal Responsibility Act of 1982]." *Id.*

Circuit was careful to distinguish the district court opinion in the instant case and to clarify that its "conclusion would likely be entirely different if Carlton had engaged in his transaction after January 5, 1987." *Id.* at 1062, *citing Ferman*, 790 F.Supp. at 656.

Although Notice 87-13 did not carry the authority of binding law, it did notify taxpayers of the possibility that section 2057 would be amended, how section 2057 might be amended, and the fact that there was risk associated with entering into transactions solely out of reliance upon section 2057. To hold that Notice 87-13 had no such effect would be to invite taxpayers to use notices – which, as is established in the record, are issued by the IRS to inform Congress of its errors in drafting tax legislation – to locate Congress' mistakes and exploit them before they are corrected. Moreover, although one month may not constitute abundant notice, Ferman and her attorneys had every reason to remain observant for signs of change to section 2057. Specifically, although the transactions at issue cost the decedent's estate $49,057.50 in the form of deductions given to the ALZA ESOP, these transactions, in the absence of an amendment to section 2057, subjected the estate to a relatively low amount of risk and reduced its taxable amount by $466,046.25, or twenty-five percent. The result was a $177,362.03 reduction in federal estate tax. Although it is indisputable that section 2057 was passed to encourage the growth of ESOP's, the transactions at issue brought about an immediate benefit to the estate – and cost to the federal government through lost tax revenue – that was nearly four times greater than

the deductions received by the ALZA ESOP.[10] Accordingly, we conclude that Notice 87-13 reasonably forewarned Ferman and her attorneys of Congress' amendment to section 2057. *See Milliken v. United States*, 283 U.S. 15, 21-24, 51 S.Ct. 324, 327, 75 L.Ed. 809 (1931) (upholding a retroactive gift tax where the donor was forewarned of the possibility of this tax); *Estate of Ekins v. Commissioner*, 797 F.2d 481, 484 (7th Cir.1986) ("[T]he application of a tax statute will not amount to a deprivation of property without due process of law if it meets two tests: the change is reasonably foreseeable and is only a fluctuation in the tax rate instead of a wholly new tax.").

Second, in amending section 2057, Congress was careful not to completely eliminate the deduction for taxpayers who relied upon it in their estate planning, as indicated by their (1) directly purchasing the securities before their deaths and (2) providing that these securities

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[10] As stated by Judge Norris in his dissent to the *Carlton* majority opinion,

> [T]he statute on its face offered a benefit that appeared "too good to be true." Admittedly, a number of laws provide tax incentives to encourage the growth of ESOPs, in some cases subsidizing third parties for facilitating the transfer of employer securities to an ESOP. . . . But the outcome in this case . . . demonstrates that the deduction as drafted offered a subsidy of a wholly different magnitude from existing provisions. Congress could more providently have underwritten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!

972 F.2d at 1066.

be allocated or held for future allocation in specified ways. *See* Pub.L. No. 100-203 § 10411, 101 Stat. 1330, 1330-432 (1987).[11] The transactions at issue in the case before us, rather than being part of Paglin's estate planning, were entered into after his death solely to take advantage of the deduction offered under section 2057.

When regulating economic activity, Congress generally enjoys wide latitude to legislate retroactively. *See Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 729, 104 S.Ct. 2709, 2717-18, 81 L.Ed.2d 601 (1984);[12] *see also supra* note 5 (equating the standards of review for

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[11] Section 10411(d) provides that:

(1) *In general.* – For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless –

(A) the decedent directly owned the securities immediately before death, and

(B) after the sale, the employer securities –

(i) are allocated to participants, or

(ii) are held for future allocation in connection with

(I) an exempt loan under the rules of section 4975, or

(II) a transfer of assets under the rules of section 4980(c)(3).

[12] In *Pension*, the Court explained that:

> the strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means, judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . .

467 U.S. at 729, 104 S.Ct. at 2717-18.

the retroactive application of statutes in and outside of the tax context). Moreover, the Supreme Court observed long ago that "[n]o more essential or important power has been conferred upon the Congress [than the power to collect taxes and raise revenues,] and the presumption that an Act of Congress is valid applies with added force and weight to a levy of public revenue." *United States v. Jacobs*, 306 U.S. 363, 370, 59 S.Ct. 551, 555, 83 L.Ed. 763 (1939) (footnote omitted). Although Congress acted retroactively when amending section 2057, it was merely correcting a substantial error[13] publicly acknowledged through Notice 87-13 just three months after that error was made. Proposed legislation confirming the position taken by the IRS in Notice 87-13 was introduced into Congress the following month. And, at the time section 2057 was actually amended (just one week after Ferman filed a refund claim with the IRS for $177,362.03), the deduction had been in existence for just a little more than one year. *See Wiggins*, 904 F.2d at 315 (in upholding a corrective tax statute applied retroactively, stating that "[w]here legislation is curative, retroactive application may be constitutional despite a long period of retroactivity"); *cf. United States v. Hudson*, 299 U.S. 498, 500, 57 S.Ct. 309, 310, 81 L.Ed. 370 (1937) ("[I]t long has been

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[13] Congress anticipated that the revenue loss resulting from the passage of section 2057 would be approximately $300 million. Because section 2057 was not specifically limited to instances where the decedent owned the employer securities at the time of his or her death, the potential revenue loss resulting from 2057 as originally drafted was estimated at $7 billion. *See* 133 CONG.REC. H845 (daily ed. Feb. 26, 1987).

the practice of Congress to make [income tax statutes] . . . retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment. . . . ") (citations omitted). Having analyzed the effect of Congress' retroactive amendment to section 2057 in the context of the facts before us, we conclude that limiting the scope of section 2057 to exclude the transactions at issue in this case does not constitute a change in tax law "so harsh and oppressive as to transgress the constitutional limitation." *Hemme*, 476 U.S. at 568-69, 106 S.Ct. at 2078; *Welch*, 305 U.S. at 147, 59 S.Ct. at 125.

III. CONCLUSION

For the foregoing reasons, we AFFIRM the district court's grant of summary judgment in favor of the government.

APPENDIX B

Bertha Paglin FERMAN, as Executrix of the Estate of Jules J. Paglin

v.

UNITED STATES of America.

Civ. A. No. 90-1878.

United States District Court,
E.D. Louisiana.

April 20, 1992.

Executrix brought suit on behalf of estate, claiming refund. On cross motions for summary judgment, the District Court, Arceneaux, J., held that retroactive amendment of Internal Revenue Code to require that decedent have owned employer securities sold to Employee Stock Ownership Plan (ESOP) prior to his death in order for estate to claim 50% deduction from gross estate for proceeds resulting from the sale did not violate due process.

Defendant's motion granted.

Jack M. Weiss, Steven W. Usdin, Paul O.H. Pigman, David J. Lukinovich, Dorothy Hudson Wimberly, Stone, Pigman, Walther, Wittmann & Hutchinson, New Orleans, La., Irving Ferman, Howard University Law School, Washington, D.C., for plaintiff.

Steven Gremminger, U.S. Dept. of Justice, Tax Div., Washington, D.C., John P. Volz, Harry A. Rosenberg, U.S. Attorney's Office, New Orleans, La., for defendant.

ORDER AND REASONS

ARCENEAUX, District Judge.

Plaintiff, Bertha Paglin Ferman ("Ferman"), as executrix of the estate of Jules J. Paglin, and defendant, the United States of America (the "Government"), filed cross motions for summary judgment and noticed these motions for hearing on April 2, 1992. Having reviewed the memoranda in support, the opposition memoranda, the record, and the applicable law, and having heard the oral argument of counsel, the court now rules.

FACTS

Plaintiff filed this action on May 25, 1990. In her complaint, Ferman claims that the Internal Revenue Service (the "IRS") owes the Paglin estate a $177,362.03 refund plus interest and the costs, expenses, and reasonable attorneys' fees incurred in prosecuting this action. The parties have stipulated to the relevant facts.

Congress enacted section 2057 of the Internal Revenue Code (the "Code") as part of the Tax Reform Act of 1986, on October 26, 1986. *See* Tax Reform Act of 1986, Pub.L. No. 99-514, § 1172(a), 100 Stat. 2085, 2513-15. Section 2057 (as originally enacted) provided in pertinent part:

> Sec. 2057. Sales of Employer Securities to Employee Stock Ownership Plans or Worker-Owned Cooperatives
>
> (a) General Rule. – For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting

from the value of the gross estate an amount equal to 50 percent of the qualified proceeds of a qualified sale of employer securities.

(b) Qualified Sale. – For purposes of this section, the term "qualified sale" means any sale of employer securities by the executor of an estate to –

(1) an employee stock ownership plan is [sic] described in section 4975(e)(7), or

(2) an eligible worker-owned cooperative (within the meaning of section 1042(c)).

(c) Qualified Proceeds. – For purposes of this section –

(1) In General. – The term "qualified proceeds" means the amount received by the estate from the sale of employer securities at any time before the date on which the return of the tax imposed by section 2001 is required to be filed (including any extensions).

(2) Proceeds from Certain Securities Not Qualified. – The term "qualified proceeds" shall not include the proceeds from the sale of any employer securities if such securities were received by the decedent –

(A) in a distribution from a plan exempt from tax under section 501(a) which meets the requirements of section 401(a), or

(B) as a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

Id. § 1172(a), at 2513-14. In essence, this new section to the Code allowed a fifty percent deduction from the gross

estate of qualified proceeds resulting from a qualified sale of employer securities to an Employee Stock Ownership Plan ("ESOP"). The new provision took effect upon enactment of the Tax Reform Act of 1986.

Jules J. Paglin died testate on October 27, 1986, in the Parish of Orleans, State of Louisiana. On October 29, 1986, Ferman, as executrix, probated Paglin's will in the Civil District Court for the Parish of Orleans, State of Louisiana. She subsequently qualified as the testamentary executrix in the proceeding styled *Succession of Jules J. Paglin*, No. 86-19726. The decedent also had named Ferman as the primary beneficiary under his will.

Mrs. Ferman characterizes herself as a "sophisticated investor" but also a conservative investor. The parties further stipulate that her testimony would reveal that she and her husband made substantial investments on their own account. In addition, her testimony apparently would establish the [sic] she and her husband invested in stocks on occasion but, by 1987, they discontinued further stock investments because of the risk involved.

Mr. Paglin, the decedent, owned shares in over seventy-five publicly traded corporations at the time of his death. In addition, the decedent did not own more than $25,000 worth of stock in any one company – except for 100 shares of ALZA Corporation stock.[1] The estate still owns these shares. Mr. Paglin, however, had no legal

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[1] The ALZA Corporation is a publicly traded corporation located in Palo Alto, California, and listed on the American Stock Exchange.

relationship to or with the ALZA ESOP at the time of his death.

The IRS issued Notice 87-13 on January 5, 1987, including a specific Question and Answer 23. *See* Rev.Rul. 87-13, 1987-1 C.B. 20. This notice purported to clarify the interpretation and legislative intent behind section 2057 of the Code pending the enactment of legislation. In so doing, the IRS stated that section 2057 required a decedent to own the ESOP shares prior to his death for the estate to qualify for the fifty percent deduction.

Ferman, in her capacity as executrix of Jules J. Paglin's succession, opened an account on or before February 20, 1987, with Dean, Witter, Reynolds, Inc. ("Dean, Witter") of Palo Alto, California. She deposited $350,000 in cash funds through Jeffrey Traum of Dean, Witter for the purpose of transactions involving Class A common stock of ALZA Corporation.

The trustees of the ALZA ESOP contemporaneously executed three Stock Purchase Agreements for the purchase of Class A common stock of ALZA Corporation on February 20th, 23rd, and 24th of 1987. Pursuant to these contractual undertakings, the trustees purchased approximately 35,700 shares of ALZA Corporation stock from the Estate of Jules J. Paglin on these three dates. The purchases resulted in an aggregate discount to the ALZA ESOP (and loss to the estate) of $49,057.50. The parties stipulate that an ALZA Corporation officer executed the consents required by the Tax Reform Act of 1986 for these transactions to be valid.

The parties also stipulate that Mrs. Ferman arranged for these transactions with one purpose in mind: her attorneys had advised her that, by purchasing and reselling the ALZA Corporation stock to an ESOP, the estate could be entitled to a tax deduction under section 2057 of the Code. Mrs. Ferman, therefore, decided to arrange for these transactions after considering her attorneys' advice and considering the benefits to the estate. She chose the ALZA ESOP because it had agreed to purchase the shares at the lowest discount.

Mrs. Ferman timely filed a United States Estate Tax Return (U.S. Treasury Form 706) on or about July 17, 1987. The decedent's federal estate tax return reflected a total gross estate of $2,786,691.42, with total allowable deductions of $916,852.39, resulting in a taxable estate of $1,869,839.03. The plaintiff included a check to the IRS for $511,097.55 as the federal estate tax reflected on the return.

The transactions involving the ALZA Corporation stock resulted in reducing the taxable estate from $1,869,839.03 to $1,403,792.78, a reduction of $466,046.25. This reduction in the taxable estate reduced the tax due from $511,097.55 to $333,735.52, resulting in a refund claim of $177,362.03. Mrs. Ferman filed a claim for refund (U.S. Treasury Form 843) on December 15, 1987.

Congress retroactively amended section 2057 of the IRS Code one week later on December 22, 1987. *See* Omnibus Budget Reconciliation Act of 1987 ("OBRA"), Pub.L. No. 100-203, § 10411, 101 Stat. 1330. In so doing, Congress provided that, for purposes of the fifty percent

deduction, a decedent must have owned the stock sold to an ESOP by his estate prior to his or her death.[2]

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[2] The retroactive amendment to section 2057 stated, in relevant part:

Sec. 10411. Congressional Clarification of Estate Tax Deduction for Sales of Employer Securities.

(a) Intent of Congress in Enacting Section 2057 of the Internal Revenue Code of 1986. – Section 2057 (relating to sales of employer securities to employee stock ownership plans or worker-owned cooperatives) is amended by redesignating subsections (d), (e), and (f) as subsections (e), (f), and (g), respectively, and by inserting after subsection (c) the following new subsection:

* * *

(d) Qualified Proceeds from Qualified Sales. –

(1) In General. – For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless –

(A) the decedent directly owned the securities immediately before death, and

(B) after the sale, the employer securities –

(i) are allocated to participants, or

(ii) are held for future allocation in connection with –

(I) an exempt loan under the rules of section 4975, or

(II) a transfer of assets under the rules of section 4980(c)(3).

(2) No Substitution Permitted. – For purposes of paragraph (1)(B), except in the case of a bona fide business transaction (e.g., a substitution of employer securities in connection with a merger of employers), employer securities shall not be treated as allocated or held for future allocation to the extent that such

The Internal Revenue Service subsequently disallowed the Paglin estate's refund claim in full by letter dated January 31, 1990. A revenue agent's report dated December 11, 1989, accompanied this letter. In addition, the IRS had issued a private letter ruling on September 22, 1989, that re-affirmed the position taken in Notice 87-13. *See* Priv.Ltr.Rul. 89-52-003, 1989 PRL LEXIS 3088 (Sept. 22, 1989). Mrs. Ferman, therefore, instituted the instant action on behalf of the estate to contest the IRS' ruling and refusal to pay the estate's claimed refund.

Plaintiff, in both moving for summary judgment and opposing the Government's motion, attacks the IRS' refusal to pay the refund on two grounds. Ferman first argues that she fully complied with the plain meaning of section 2057 of the Internal Revenue Code as it existed at the time. The plaintiff next contends that the retroactive amendment of section 2057 as applied to the facts of this case violated the Due Process Clause of the Fifth Amendment to the United States Constitution.

The Government also has moved the court for summary judgment and opposes the plaintiff's motion. In

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securities are allocated or held for future in substitution of other employer securities that had been allocated or held for future allocation.

(b) Effective Date. – The amendments made by subsection (a) shall take effect as if included in the amendments made by section 1172 of the Tax Reform Act of 1986.

Omnibus Budget Reconciliation Act of 1987, Pub.L. No. 100-203, § 10411, 101 Stat. 1330.

addressing the plain meaning rule, the defendant essentially argues that the plain meaning rule bears no relevance to section 2057's constitutionality. In so arguing, the Government avers that Congress acted within its constitutional powers and did not offend due process by retroactively amending section 2057. Furthermore, the Government posits that, even assuming the plain meaning rule should apply, plaintiff has not met the burden of proving that the IRS misinterpreted or misapplied the statute.

DISCUSSION

This case presents a novel issue of first and, most likely, last impression. The issue presented is whether the retroactive amendment by Congress of section 2057 of the Tax Reform Act of 1986 violated the Due Process Clause of the United States Constitution. In the court's view, plaintiff simply fails to establish that, under the relevant jurisprudence, a constitutional violation has occurred.

1. The Plain Meaning Rule

The court first addresses plaintiff's arguments relative to the plain meaning rule. In so doing, the court finds these arguments persuasive but, as discussed below, not persuasive enough to overcome the prevailing jurisprudence.

The rules of statutory construction treat tax statutes no differently than any other legislative enactment. *See generally* 1 Joseph Rasch, *Handling Federal Estate and Gift Taxes* § 1:6 (4th ed. 1984) (discussing principles involved

in interpreting estate tax legislation). Plaintiff properly instructs the court that, if it finds a statute's terms to be unambiguous, the "plain meaning rule" requires courts to give statutes their ordinary meaning unless such ordinary meaning leads to absurd results. *Bob Jones Univ. v. United States*, 461 U.S. 574, 586, 103 S.Ct. 2017, 2025, 76 L.Ed.2d 157 (1983). Ferman also correctly points out the clear and unambiguous language of the former section 2057. This section required no interpretation and its clarity precludes the use of Congressional legislative history to fathom its meaning.[3]

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[3] It is interesting to note that at least one senator's views apparently lend credence to the IRS' position in Notice 87-13. Senator Russell Long, Finance Committee Chairman, a most vigorous advocate of ESOPs and generally regarded as the author of the concept contained in section 2057, noted during the Senate's debate:

> The amendment allows an exclusion from an estate for 50 percent of the proceeds realized on an estate's sale of stock to an ESOP, thereby allowing an executor to reduce taxes on an estate by one-half by selling *the decedent's company* to an ESOP or worker owned cooperative. . . . This amendment should encourage sales of companies to employee stock ownership plans. In addition, it should help reduce estate taxes. The only real purpose of the estate tax is to break up large accumulations of capital. Tax relief is appropriate for the estates of those who assist others in accumulating capital – *particularly when they help those who helped them accumulate that capital.*

132 Cong.Rec. 14,507 (1986) (statement of Sen. Long) (emphasis added). Senator Long's statement lends substantial credence to the IRS' interpretation of section 2057. By referring to "the decedent's company", the senator indicates legislative intent for a decedent to own the subject stock prior to his death for his estate to claim the deduction.

The IRS' interpretation of section 2057 in Notice 87-13 does not appear to be inconsistent with Congress' intent at the time of its original enactment and clearly comports with the subsequent amendment. But, where a court finds a statute's language clear and unambiguous, it is error to resort to legislative history to explain it. *See United States v. American Trucking Assns.*, 310 U.S. 534, 543, 60 S.Ct. 1059, 1063, 84 L.Ed. 1345 (1940); *United States v. Northumberland Ins. Co.*, 521 F.Supp. 70, 76 (D.N.J.1981). The court finds that, without resorting to section 2057's legislative history, Ferman complied with the former section 2057's provisions to qualify the Paglin estate for the fifty percent deduction. This finding, however, does not end the court's analysis.

2. Retroactivity and Due Process

The plaintiff's second and final attack on section 2057 argues that Congress' retroactive amendment to this section violated her due process rights. Ferman, however, fails to sustain such contention under the relevant jurisprudence.

The parties have supplied the court with the unpublished decision of the only other federal court known to have considered this specific issue. In *Carlton v.*

Of course, it is likewise arguably correct that Mrs. Ferman's conduct furthered the purpose of the statute by helping "those who helped them accumulate that capital." By her purchases, she reduced the number of outstanding "market-place" shares of ALZA Corporation stock and caused these shares to be acquired by the ESOP. This result certainly appears to satisfy the intent behind section 2057 as well.

United States, No. 90-685 (C.D.Cal. Apr. 15, 1991), the U.S. District Court for the Central District of California held that the retroactive amendment to section 2057 did not violate due process and granted summary judgment in favor of the government.[4] While not controlling, the court finds no error in the *Carlton* court's analysis.

The relevant jurisprudence instructs this court that "the application of a tax statute will not amount to a deprivation of property without due process of law if it meets two tests: the change is reasonably foreseeable and is only a fluctuation in the tax rate instead of a wholly new tax." *Estate of Ekins v. Commissioner*, 797 F.2d 481, 484 (7th Cir.1986) (*citing United States v. Darusmont*, 449 U.S. 292, 299-300, 101 S.Ct. 549, 553-554, 66 L.Ed.2d 513 (1981); *Welch v. Henry*, 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938); *Milliken v. United States*, 283 U.S. 15, 23-24, 51 S.Ct. 324, 327-328, 75 L.Ed. 809 (1931)). The net effect of the jurisprudence interpreting retroactive tax statutes undermines Ferman's position.

Plaintiff may have followed the plain and ordinary construction of section 2057 as originally enacted, but the court finds strong, indeed virtually unanimous, support for retroactive application of tax statutes. *See Darusmont*, 449 U.S. at 296, 101 S.Ct. at 551; *Welch*, 305 U.S. at 146-50, 59 S.Ct. at 125-127; *Milliken*, 283 U.S. at 24, 51 S.Ct. at 327;

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[4] The court notes that the plaintiff in *Carlton* voiced other objections to the amendment including violations of the Contract and Takings Clauses of the United States Constitution. Ferman, in this case, has not raised such issues, but, even if she had, the court would have found them to be unpersuasive for the reasons expressed in the *Carlton* decision.

see also 2 Norman A. Singer, *Sutherland Statutory Construction* § 41.10 (4th ed. 1986) (noting validity of retroactively-applied tax statutes). Neither party contests that Congress, by its 1987 amendment to section 2057, did not intend to limit the sales of stocks to ESOPs and make such limitation retroactive. The question, therefore, becomes whether such retroactive intent and application violated the plaintiff's constitutional rights.

Ferman initially contends that she could not have foreseen Congress' retroactive amendment of section 2057 because no legislative action took place until after she completed the stock transfers at issue. The foreseeability of this tax statute turns on the first instance where plaintiff knew or should have known of the impending change in section 2057. The Government obviously argues that Notice 87-13 (published the month before plaintiff engaged in the relevant transactions) provided Mrs. Ferman with ample notice of section 2057's practical application.

Notice 87-13 forewarned what the future could and ultimately did bring. While the IRS cannot legislate, its pronouncements as to the application of tax laws deserve deference. *Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501, 68 S.Ct. 695, 698, 92 L.Ed. 831 (1948); *see* Singer, *supra*, § 66.04. The contention that Notice 87-13 failed to present the plaintiff with the IRS' (or, prospectively, Congress') intended interpretation of section 2057 is unpersuasive. It would seem abundantly clear that, given the IRS' position, Congress would enact corrective and retroactive legislation at the earliest possible time.

The Supreme Court, however, has expressed some doubt that foreseeability should even be a relevant consideration in the due process analysis of retroactive legislation. *See Pension Benefit Guar. Corp. v. Gray & Co.*, 467 U.S. 717, 731-32, 104 S.Ct. 2709, 2718-19, 81 L.Ed.2d 601 (1984); *Darusmont*, 449 U.S. at 299, 101 S.Ct. at 553. The U.S. Court of Appeals for the Seventh Circuit in *Estate of Ekins* specifically noted that foreseeability must be linked to whether the retroactive legislation changed the tax rate or added a new tax. 797 F.2d at 484. In this case, the court is unable to find that, as a matter of law, the retroactive legislation at issue created a new tax.

While the net effect of the 1987 amendments to section 2057 clearly denied the Paglin estate the benefits of the fifty percent deduction, such denial did not amount to a "new tax" as contemplated by the relevant law. The estate tax and, in particular, section 2057 existed prior to the retroactive legislation in dispute. Congress merely changed the benefits conferred by this particular provision and made such change retroactive.

Plaintiff responds that such retroactivity resulted in a harsh and oppressive effect on her and deprived her of expected tax benefits. In supporting this contention, Ferman relies on cases such as *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), and *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206 (1927), where the Supreme Court struck down the taxing gifts made prior to enactment of the legislation as arbitrary and capricious. She further distinguishes retroactive application of tax statutes in estate tax cases from income tax cases. In essence, plaintiff contends that, because the estate's right to the fifty percent deduction "vested" prior

to Congress Congress [sic] even considering section 2057's amendment, retroactive application of this legislation would violate due process.

The opinions in *Milliken* and *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986), however, teach this court otherwise. In *Milliken*, the Court apparently confines *Untermyer* to the particular facts of that case and only where a new tax has been created. *See Milliken*, 283 U.S. at 21, 51 S.Ct. at 326; *Estate of Ekins*, 797 F.2d at 484. In *Hemme*, the Supreme Court specifically stated that "[*Untermyer's*] authority is of limited value in assessing the constitutionality of subsequent amendments that bring about certain changes in operation of the tax laws, rather than creation of a wholly new tax." 476 U.S. at 568, 106 S.Ct. at 2077. The *Hemme* opinion (and numerous others), therefore, place into question the usefulness of *Blodgett* and *Untermyer* and, in this case, the plaintiff's reliance on this jurisprudence for support.

The court, even assuming arguendo that *Blodgett* and *Untermyer* stand for persuasive statements of law in estate taxation and the "vesting" of certain rights, finds such jurisprudence distinguishable. In *Blodgett* and *Untermyer*, Congress sought to enact a completely new estate tax on intervivos gifts. *Untermyer*, 276 U.S. at 444, 48 S.Ct. at 354; *Blodgett*, 275 U.S. at 146, 48 S.Ct. at 106. This case, however, does not involve a new estate tax on intervivos gifts but, rather, a change in the application of an estate tax deduction. This court, therefore, cannot find Congress' retroactive enforcement of section 2057's amendment to have been arbitrary or capricious and, as a result,

to have been a deprivation of property without due process. *See Hemme*, 476 U.S. at 568, 106 S.Ct. at 2077; *Darusmont*, 449 U.S. at 299, 101 S.Ct. at 553; *Milliken*, 283 U.S. at 20-22, 51 S.Ct. at 326-327. For this reason, Ferman's arguments relative to the estate's "vested" right in the fifty percent deduction founder on the rocks of Supreme Court case law.

The United States Constitution and jurisprudence interpreting it clearly permit Congress to legislate rationally in establishing a tax revenue base. Indeed, the Supreme Court apparently has accepted that

> it long has been the practice of Congress to make [income tax statutes] . . . retroactive for relatively short periods so as to include profits from transactions consummated while the statute was in process of enactment, or within so much of the calendar year as preceded the enactment; and repeated decisions of this Court have recognized this practice and sustained it as consistent with the due process of law clause of the Constitution.

United States v. Hudson, 299 U.S. 498, 499, 57 S.Ct. 309, 309, 81 L.Ed. 370 (1937) (citations omitted). The *Hudson* case involved income taxes rather than estate taxes, but the Court's endorsement of retroactive legislation to change existing taxes applies with equal force.

Under the circumstances, neither Ferman's expectations nor the actual undertaking of the stock transactions amounted to a "vesting" of any right in this particular tax benefit or a subsequent violation of her due process rights. For this reason, the court finds her arguments relative to such due process violation to be unpersuasive.

CONCLUSION

The Court sympathizes with and is instinctively inclined towards the position advocated by the plaintiff. It seems fundamentally wrong for federal taxing authorities to be permitted a retroactive application of a tax in the face of the clear and unambiguous language of a statute. It may well be true that Congress, perhaps inadvertently, made a mistake. The error may have occurred in the drafting process, but neither its origin or source should be relevant in considering an unambiguous choice of statutory language. In any event, it is true beyond peradventure that Congress may surely correct any error or inadvertence it may have created; indeed, Congress is constitutionally able to change and modify our nation's tax laws at will.

But, granting such amendments retroactive effect in such a way as to adversely affect completed conduct by a citizen smacks of totalitarianism through taxation. It seems fundamentally wrong for Congress to be permitted to make any of its pronouncements retroactive to the detriment of even one citizen for even one moment.

Such circumstance, however, seems to be the law and, while this court disagrees with it, it is nonetheless bound by it. It is therefore with duty-bound distaste that the court finds the Government's motion for summary judgment must be granted and the plaintiff's motion denied.

In all candor, the court, in this instance, sincerely hopes that, should its judgment be appealed, the court (or courts) above will find error in this ruling. Thus, in accepting the Government's argument that the language

in section 2057's 1986 version may be explained by inadvertence and error, this court opines the hope that the appellate courts might treat this court's ruling in a similar way; that is, while not inadvertent, the ruling is nonetheless in error.

For the reasons herein, the plaintiff's motion for summary judgment is hereby DENIED, and the defendant's motion for summary judgment is hereby GRANTED. Judgment shall be entered accordingly.

IT IS SO ORDERED.

APPENDIX C

Jerry W. CARLTON, Executor of the Will of Willametta K. Day, Plaintiff-Appellant,

v.

UNITED STATES of America, Defendant-Appellee.

No. 91-55590.

United States Court of Appeals, Ninth Circuit.

Argued and Submitted May 4, 1992.

Decided Aug. 10, 1992.

After estate's tax return was audited and deficiency was paid, executor filed refund claim. The Internal Revenue Service (IRS) denied the claim, and executor filed refund action. The United States District Court for the Central District of California, Alicemarie H. Stotler, J., granted summary judgment for government, and executor appealed. The Court of Appeals, O'Scannlain, Circuit Judge, held that retroactive application of amendment to tax statute would violate due process.

Reversed and remanded with instructions.

William A. Norris, Circuit Judge, filed dissenting opinion.

Russell G. Allen, O'Melveny & Myers, Newport Beach, Cal., for plaintiff-appellant.

Teresa E. McLaughlin, U.S. Dept. of Justice, Tax Div., Washington, D.C., for defendant-appellee.

Appeal from the United States District Court for the Central District of California.

Before: ALARCON, NORRIS, and O'SCANNLAIN, Circuit Judges.

O'SCANNLAIN, Circuit Judge:

We consider whether retroactive application of an amendment to the federal estate tax portion of the Internal Revenue Code violates due process.

I

On October 22, 1986, the Tax Reform Act of 1986 ("TRA") became law. One provision of the TRA allowed an estate to deduct half of the proceeds of a sale of securities to an Employee Stock Ownership Plan ("ESOP") from a decedent's gross estate ("the ESOP proceeds deduction"). *See* 26 U.S.C. § 2057[1] (repealed 1989).

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[1] Sec. 2057. SALES OF EMPLOYER SECURITIES TO EMPLOYEE STOCK OWNERSHIP PLANS OR WORKER-OWNED COOPERATIVES.

(a) *General Rule.* – For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate an amount equal to 50 percent of the qualified proceeds of a qualified sale of employer securities.

(b) *Qualified Sale.* – For purposes of this section, the term "qualified sale" means any sale of employer securities by the executor of an estate to –

(1) an employee stock ownership plan . . . described in section 4975(e)(7), or

(2) an eligible worker-owned cooperative (within the meaning of section 1042(c)).

The result of the ESOP proceeds deduction was to remove half of the estate from the reach of the federal estate tax, to the extent the estate was comprised of money received

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(c) *Qualified Proceeds.* – For purposes of this section –

(1) *In general.* – The term "qualified proceeds" means the amount received by the estate from the sale of employer securities at any time before the date on which the return of the tax imposed by section 2001 is required to be filed (including any extensions).

(2) *Proceeds from certain securities not qualified.* – The term "qualified proceeds" shall not include the proceeds from the sale of any employer securities if such securities were received by the decedent –

(A) in a distribution from a plan exempt from tax under section 501(a) which meets the requirements of section 401(a), or

(B) as a transfer pursuant to an option or other right to acquire stock to which section 83, 422, 422A, 423, or 424 applies.

(d) *Written Statement Required.* –

(1) *In general.* – No deduction shall be allowed under subsection (a) unless the executor of the estate of the decedent files with the Secretary the statement described in paragraph (2).

(2) *Statement.* – A statement is described in this paragraph if it is a verified written statement of –

(A) the employer whose employees are covered by the plan described in subsection (b)(1), or

(B) any authorized officer of the cooperative described in subsection (b)(2), consenting to the application of section 4979A with respect to such employer or cooperative.

(e) *Employer Securities.* – For purposes of this section, the term "employer securities" has the meaning given such term by section 409(1).

(f) *Termination.* – This section shall not apply to any sale after December 31, 1991.

from the sale of stock to an ESOP. This deduction, codified at section 2057 of the Internal Revenue Code, was available to any estate that could timely file its return after the enactment date of the TRA, irrespective of the date of death of the decedent. *See* 26 U.S.C. § 2057(c)(1).

The 99th Congress adjourned on October 18, 1986. Between passage by Congress of the TRA on September 27, 1986 and adjournment, Congress considered hundreds of potential technical and clerical amendments to the TRA, but only one proposed amendment related to section 2057: deletion of an extraneous "is." Furthermore, the parties have stipulated that "[n]o bill or resolution was introduced that would have added any condition to the availability of the new [s]ection 2057 deduction other than those contained in the statute itself during the period between passage of the TRA and adjournment on October 18, 1986."

Willametta K. Day died on September 29, 1985. Because of an extension of the filing deadline not at issue here, her estate tax return was not due until December 29, 1986. As a matter of timeliness, the Day estate was potentially eligible for the ESOP proceeds deduction contained in section 2057.

Carlton was executor of the Day estate. He reviewed the TRA and determined that it was in the interest of the estate to utilize the new ESOP proceeds deduction. The parties have stipulated that *in specific reliance on the newly enacted section 2057*, Carlton purchased 1,500,000 shares of MCI stock on December 10, 1986 at an average price of $7.47 per share, for a total price of $11,206,000. Carlton chose to buy MCI shares because the trustee of the MCI

ESOP had expressed an interest in purchasing MCI shares. At the time Carlton bought the shares, however, the MCI ESOP had not entered into any legally binding agreement to buy them from him; hence, the estate bore the risk of loss if the market in MCI stock declined. Two days later, the MCI ESOP agreed to buy the shares from the estate at $7.05 per share, which was about 26 cents *below* the mean market price that day, as well as below the price at which the shares were purchased. As part of the agreement, the MCI ESOP provided documentation that it was a qualifying ESOP as required under section 2057. *See* 26 U.S.C. § 2057(e). The total sale price was $10,575,000, or $631,000 below Carlton's purchase price. The government concedes that Carlton would not have sold the shares at a discount – and consequently the MCI ESOP would not have been able to acquire shares at a discount – if not for the section 2057 deduction.

On December 29, 1986, Carlton duly filed the estate tax return, in which he deducted $5,287,500 from the gross estate pursuant to the ESOP proceeds deduction. On behalf of the estate, Carlton paid a net estate tax of $18,752,250.

On January 5, 1987, the Internal Revenue Service ("IRS") issued an advance version of Notice 87-13, which stated, inter alia, that "[p]ending the enactment of clarifying legislation," the IRS would not recognize a deduction pursuant to section 2057 unless the decedent had "directly owned" the securities before death ("the decedent ownership requirement"). Notice 87-13 was formally published on January 26, 1987. The government concedes that the decedent ownership requirement announced in

Notice 87-13 was not contained in section 2057 as originally enacted in 1986, was not contained in any amendments to the TRA passed before the 99th Congress adjourned, nor was it in any of the proposed technical and clerical amendments to the TRA considered by the 99th Congress.

On February 26, 1987, a bill was introduced in the new 100th Congress to enact into law the decedent ownership requirement as announced in Notice 87-13 ("the 1987 amendment"). The bill eventually became law on December 22, 1987, and applied the decedent ownership requirement retroactively as if the TRA as originally enacted had contained such a requirement. *See* Pub.L. No. 100-203 § 10411,[2] 101 Stat. 1330, 1330-432 (1987). The 1987

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[2] SEC. 10411. CONGRESSIONAL CLARIFICATION OF ESTATE TAX DEDUCTION FOR SALES OF EMPLOYER SECURITIES.

(a) *Intent of Congress in Enacting Section 2057 of the Internal Revenue Code of 1986.* – Section 2057 (relating to sales of employer securities to employee stock ownership plans or worker-owned cooperatives) is amended by redesignating subsections (d), (e), and (f) as subsections (e), (f), and (g), respectively, and by inserting after subsection (c) the following new subsection:

(d) *Qualified Proceeds From Qualified Sales.* –

(1) *In general.* – For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless –

(A) the decedent directly owned the securities immediately before death, and

amendment was labeled a "Congressional Clarification of Estate Tax Deduction for Sales of Employer Securities" and its legislative history included a Committee Report statement:

> As drafted, the estate tax deduction was significantly broader than what was originally contemplated by Congress in enacting the provision. The committee believes it is necessary to conform the statute to the original intent of Congress in order to prevent a significant revenue loss under the [TRA].

H.R.Rep. No. 100-391(II), 100th Cong., 1st Sess. 1045 (1987), *reprinted in* 4 U.S.C.C.A.N. 2313-1, 2313-661 (1987).

The Day estate's tax return was audited, and the IRS determined a deficiency of $3,385,333. The net deficiency

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(B) after the sale, the employer securities –

(i) are allocated to participants, or

(ii) are held for future allocation in connection with

(I) an exempt loan under the rules of section 4975, or

(II) a transfer of assets under the rules of section 4980(c)(3).

(2) *No substitution permitted.* – For purposes of paragraph (1)(B), except in the case of a bona fide business transaction (e.g., a substitution of employer securities in connection with a merger of employers), employer securities shall not be treated as allocated or held for future allocations to the extent that such securities are allocated or held for future allocation in substitution of other employer securities that had been allocated or held for future allocation.

(b) *Effective Date.* – The amendments made by subsection (a) shall take effect as if included in the amendments made by section 1172 of the Tax Reform Act of 1986.

attributable to the disputed ESOP proceeds deduction was $2,501,161. Carlton does not dispute the remaining deficiency.

Carlton paid the total deficiency plus $996,953.18 in interest. On July 3, 1989, he filed a refund claim for that part of the deficiency attributable to the ESOP proceeds deduction. The IRS denied the refund claim. On October 11, 1990, Carlton filed a refund action in district court for $2,501,161 plus interest, costs, and attorneys' fees.

Carlton moved for summary judgment on stipulated facts, and the government moved to dismiss with prejudice, which the district court construed as a motion for summary judgment. The parties agreed to an order narrowing the potential issues in controversy. The government conceded that the estate was entitled to the ESOP proceeds deduction under section 2057 as passed in 1986, and that if the 1987 amendment could not be retroactively applied consistent with due process, that Carlton was entitled to judgment. Carlton conceded that if the 1987 amendment could be retroactively applied to his transaction, the estate would not be entitled to the ESOP proceeds deduction, that there would be no other basis for claiming the refund, and that the government would be entitled to judgment.

The district court granted the government's motion for summary judgment. The district court determined that the retroactive application of the 1987 amendment to the MCI ESOP transaction did not violate due process because the 1987 amendment did not impose a "wholly

new tax." The district court also rejected Carlton's Contract Clause and Takings Clause arguments, and Carlton does not press those points on appeal.

II

Whether a statute may be applied retroactively consistent with the Due Process Clause is a question of law, and thus we review the district court's determination on this issue de novo. *Licari v. Commissioner*, 946 F.2d 690, 692 (9th Cir. 1991).

III

A

Over the past half-century the Supreme Court has consistently stated a single standard to determine if a tax statute may be applied retroactively consistent with the Due Process Clause.[3] Courts "must 'consider the nature of the tax and the circumstances in which it is laid before

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[3] Under long-standing judicial construction the Ex Post Facto Clause does not apply here because this is not a criminal prosecution. "Although the Latin phrase *'ex post facto'* literally encompasses any law passed 'after the fact,' it has long been recognized by this Court that the constitutional prohibition on *ex post facto* laws applied only to penal statutes which disadvantage the offender affected by them." *Collins v. Youngblood*, 497 U.S. 37, ___, 110 S.Ct. 2715, 2718, 111 L.Ed.2d 30 (1990) (citing *Calder v. Bull*, 3 U.S. (3 Dall.) 386, 1 L.Ed. 648 (1798)). *See also Valley Wood Preserving, Inc. v. Paul*, 785 F.2d 751, 754 (9th Cir.1986) ("The ex post facto clause is limited to criminal proceedings and therefore has no application [to a land use ordinance].").

it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation.' " *United States v. Hemme*, 476 U.S. 558, 568-69, 106 S.Ct. 2071, 2078, 90 L.Ed.2d 538 (1986) (quoting *Welch v. Henry*, 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938)); *accord United States v. Darusmont*, 449 U.S. 292, 299, 101 S.Ct. 549, 553, 66 L.Ed.2d 513 (1981) (per curiam) (court's inquiry is "whether a particular tax is so harsh and oppressive as to be a denial of due process").[4] Outside of the tax context, the constitutional standard is often stated differently: a retroactive application of a statute must be "arbitrary and irrational" to violate due process. *See Usery v. Turner Elkhorn Mining Co.*, 428 U.S. 1, 15, 96 S.Ct. 2882, 2892, 49 L.Ed.2d 752 (1976). The Supreme Court has made clear, however, that the "harsh and oppressive" standard used in the tax context "does not differ from the prohibition against arbitrary and irrational legislation that we clearly enunciated in *Turner Elkhorn*." *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733, 104 S.Ct. 2709, 2720, 81 L.Ed.2d 601 (1984).

We are instructed to "consider the nature of the tax and the circumstances in which it is laid." We "perceive no . . . rigid standard of constitutionality in the decided cases. . . . We are guided, rather, by the more flexible criteria delineated by the Supreme Court in Welch v. Henry. . . . " *Purvis v. United States*, 501 F.2d 311, 313 (9th Cir.1974) (quotations omitted), *cert denied*, 420 U.S. 947, 95

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[4] It can hardly be said that these 1981 and 1986 cases, upon which we rely, "reach back to the *Lochner* era." *See* dissent at 1062.

S.Ct. 1329, 43 L.Ed.2d 425 (1975). Accordingly, we reject the notion of a per se rule that tax statutes can *never* be retroactively applied. The Supreme Court has "made clear that some retrospective effect is not necessarily fatal to a revenue law." *Hemme*, 476 U.S. at 568, 106 S.Ct. at 2077. Thus, retroactivity alone will not condemn a congressional enactment.

By the same token, we also reject the notion of a per se rule that tax statutes can *always* be retroactively applied so long as they do not enact a "wholly new" tax. The Supreme Court's two most recent decisions regarding retroactivity challenges to tax statutes, *Hemme* and *Darusmont*, did not involve wholly new taxes. Despite that fact, the Court engaged in a thorough analysis of the circumstances of each retroactive application before making its determination of constitutionality. This clearly indicates that retroactive application of the tax laws is not "automatically" permitted so long as a wholly new tax is not involved.

Thus, we consider whether, under "the circumstances in which it is laid," the retroactive application of the 1987 amendment of section 2057 to the MCI ESOP transaction is "so harsh and oppressive" as to violate due process. An examination of previous challenges to the constitutionality of the retroactive application of tax statutes helps to elucidate the factors we must consider in our determination.

In *Nichols v. Coolidge*, 274 U.S. 531, 47 S.Ct. 710, 71 L.Ed. 1184 (1927), the Supreme Court held a retroactive application of the federal estate tax to be unconstitutional. Mrs. Coolidge had transferred property to a trust

in 1907. Income on the trust was to be paid to Mrs. Coolidge and her husband, and after they had both died the corpus of the trust was to be divided among Mrs. Coolidge's children or their representatives. In 1919, Congress amended the federal estate tax to include within its ambit transfers made prior to death that were " 'intended to take effect in possession or enjoyment at or after . . . death.' " *Id.* at 539, 47 S.Ct. at 712 (quoting Act of February 24, 1919, § 402(c)). Such transfers were to be taxed at their value at the time of the transferor's death. Congress also expressly stated that such provision applied "whether such transfer or trust is made or created before or after the passage of this Act." *Id.* Mrs. Coolidge died in 1921 and the Commissioner of Internal Revenue sought to include within the gross taxable estate the present value of the trust corpus. Mrs. Coolidge, of course, had no notice that the trust corpus would be taxed as part of her estate when she created the trust in 1907. The Court also emphasized that "[a]n excise is prescribed, but the amount of it is made to depend upon past lawful transactions, not testamentary in character and beyond recall." *Id.* at 542, 47 S.Ct. at 714-15. Thus, the Court concluded that the retroactive application of the 1919 amendment was "so arbitrary and capricious as to amount to confiscation and offend the Fifth Amendment." *Id.*

The next Term, the Supreme Court again faced a challenge to the retroactive application of a federal tax statute. In *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206 (1927), four members of the Court viewed a retroactive application of the federal gift tax as violative

of due process.[5] Blodgett made gifts in January 1924. The gift tax provision in question was presented to Congress for consideration on February 25, 1924, and approved on June 2, 1924. The plurality pointed out that the gifts had been made before the new statute was even pending before Congress. It concluded that "[i]t seems wholly unreasonable that one who, in entire good faith and without the slightest premonition of such consequence, made absolute disposition of his property by gifts should thereafter be required to pay a charge for so doing." *Id.* at 147, 48 S.Ct. at 106 (opinion of McReynolds, J.).

Later in the same Term, the Court revisited the question of the retroactive application of the 1924 federal gift tax legislation. In *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), the gift was made on May 23, 1924. Hence, unlike in *Blodgett*, the gift was made after Congress had begun consideration of the legislation, although still before such legislation was enacted. Nonetheless, the Court still found the retroactive application to offend due process.

> The mere fact that a gift was made while the bill containing the questioned provisions was in the last stage of progress through Congress we think is not enough to differentiate this cause from [*Blodgett*] and to relieve the legislation of

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[5] This opinion by Justice McReynolds was joined by Chief Justice Taft and Justices Van Devanter and Butler. Justice Holmes, joined by Justices Brandeis, Sanford and Stone, was of the view that the statute could be read to not apply retroactively, thus avoiding the constitutional question. No vote is recorded for Justice Sutherland, and thus the Court was evenly divided on this issue.

> the arbitrary character there ascribed to it. . . . The taxpayer may justly demand to know when and how he becomes liable for taxes – he cannot foresee and ought not to be required to guess the outcome of pending measures. The future of every bill while before Congress is necessarily uncertain.

Id. at 445-46, 48 S.Ct. at 354.

This court too has held that a federal tax as applied was unconstitutionally retroactive. *See Wheeler v. Commissioner*, 143 F.2d 162, 168 (9th Cir.1944), *rev'd on other grounds*, 324 U.S. 542, 65 S.Ct. 799, 89 L.Ed. 1166 (1945). In reliance on the Revenue Act of 1938, the shareholders of the John H. Wheeler company dissolved the corporation and distributed its assets proportionately among themselves. Under the Revenue Act of 1938, the capital gains of the dissolved corporation were measured for tax purposes as if the corporation had bought all its assets at market value. That is, the basis of certain assets was taken as the market value at the time the assets were transferred from shareholders to the corporation. The Second Revenue Act of 1940, however, purported to change the rule retroactively for corporations liquidated under the Revenue Act of 1938. Under the 1940 Act, the corporation assumed the transferor-shareholder's basis, rather than taking as its basis the market value at the time of transfer. This court held that the Second Revenue Act of 1940 had not "come within the next session of the legislature [following passage of the 1938 Act] or within a reasonable length of time" and hence could not be retroactively applied to the Wheelers' 1938 corporate dissolution consistent with due process. *Id.* at 168.

We have recently stated that "[f]ederal courts have long been hostile to legislation that interferes with settled expectations." *Licari*, 946 F.2d at 693. Still, it cannot be gainsaid that the modern trend has been against successful challenges to retroactive applications of the tax statutes. In three modern cases, the Supreme Court has rejected due process challenges to retroactive applications of revenue acts.

In *Welch v. Henry*, 305 U.S. 134, 59 S.Ct. 121, 83 L.Ed. 87 (1938), the challenged revenue act retroactively imposed a tax on certain dividend income that had formerly been excluded from taxation. There was no indication that the taxpayer had incurred any extra expenses or in any other way changed his conduct in reliance on the tax law as it stood before retroactive amendment. In holding the retroactive tax constitutional, the Court observed, "[w]e can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one." *Id.* at 148, 59 S.Ct. at 126. The Court stated, however, that a different case would be presented where a transaction was taxed that was "completely vested before the enactment of the taxing statute," and "the nature or amount of the tax could not reasonably have been anticipated by the taxpayer at the time of the particular voluntary act which the statute later made the taxable event." *Id.* at 147, 59 S.Ct. at 125.

In *United States v. Darusmont*, 449 U.S. 292, 101 S.Ct. 549, 66 L.Ed.2d 513 (1981) (per curiam), the taxpayer unsuccessfully challenged the retroactive application of a change in the minimum tax that increased the tax on an already completed sale of real property. Far from relying

on the pre-amendment law, the taxpayer "conceded . . . that when he was considering the various ways in which he could dispose of the Texas property, he was *not aware* of the existence of the minimum tax." *Id.* at 295, 101 S.Ct. at 551 (emphasis added). The Court further observed that the taxpayer was "hardly in a position to claim surprise at the 1976 amendments to the minimum tax. The proposed increase in rate had been under public consideration for almost a year before its enactment." *Id.* at 299, 101 S.Ct. at 553. Also significant was that the 1976 amendments merely "decreas[ed] the allowable exemption and increas[ed] the percentage rate of tax." *Id.* at 300, 101 S.Ct. at 553.

In *United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986), the retroactive application of a transitional rule[6] to gifts made before its enactment was challenged on due process grounds. In concluding that due process was not violated, the Court put great weight on the fact that the taxpayers were "no worse off than they would have been without the enactment of the Act." *Id.* at 570, 106 S.Ct. at 2079. The Court noted that even under the retroactive operation of the transitional rule, the taxpayers "still have paid estate taxes of $655.16 *less* than they would have paid had the 1976 Act never been passed" and that accordingly "the retroactive aspect of the law could not be said to be oppressive or inequitable." *Id.* at 571, 106 S.Ct. at 2079. The Court also found it significant that "§ 2035 had long been in effect at the time

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[6] The transitional rule was "enacted to bridge the old and new regimes for the federal taxation of gifts and estates." *Hemme*, 476 U.S. at 560, 106 S.Ct. at 2073.

[the decedent] made his gift, and it is § 2035 that contains the principal retroactive feature involved in this case, requiring the estate to reach back and embrace a gift made over two years previously." *Id.*

This court recently decided a challenge to an increase in the penalty rate from 10% to 25% for underpayment of tax liability, retroactively applied to tax returns filed before the date of enactment where penalties had not yet been assessed as of the enactment date. *Licari*, 946 F.2d at 692. We concluded that the retroactive aspect of the statute was rational because it served to make those who were trying to cheat "reimburs[e] the government for [the] heavy burden of investigative and prosecutorial costs incident to ferreting out tax underpayment." *Id.* at 695. We were careful to point out, however, that:

> [h]ere, *we are not presented with a case in which an individual acted in accordance with the law as it stood at the time* only later to be subjected to a penalty; instead, those subjected to the increased penalties, like the Licaris, knew at the time that they filed their returns that they were not acting in accordance with the law and could be subjected to a fine. . . . Under these circumstances, we do not find imposition of the increased penalty unduly "harsh and oppressive."

Id. at 695 (emphasis added).

B

From these cases, two circumstances emerge as of paramount importance in determining whether the retroactive application of a tax is unduly harsh and oppressive. First, did the taxpayer have actual or constructive

notice that the tax statute would be retroactively amended? Second, did the taxpayer rely to his detriment on the pre-amendment tax statute, and was such reliance reasonable? We address each question in turn.

It is undisputed that Carlton had no actual notice of the 1987 amendment imposing the decedent ownership requirement when he completed the MCI ESOP transaction in 1986. Nor is there any basis upon which Carlton could have had constructive notice of the future imposition of the decedent ownership requirement. The Day estate completed its transaction before the end of December 1986. The IRS first proposed that section 2057 be amended to include a decedent ownership requirement on January 5, 1987. The bill that included the 1987 amendment was introduced in Congress on February 26, 1987. Moreover, the government concedes that the decedent ownership requirement was not "identified in the proposed technical and clerical amendments discussed before Congress adjourned," and was not "added to the statute (although other changes to the TRA were made) before Congress adjourned" on October 18, 1986. Hence, no act of the executive or legislative branch would have given any forewarning of the 1987 amendment at the time the MCI ESOP transaction occurred.

The government argues, however, that the legislative history of the TRA should have put Carlton on constructive notice that Congress had intended to include a decedent ownership requirement in section 2057, and that an amendment imposing such a requirement was surely in the offing. The government, however, can only point to two passing references in congressional documents in support of its view. Both of these references merely state

that the ESOP proceeds deduction would be *available* to a decedent who sold his company to an employee group. The government can point to no place in the legislative history that states that the ESOP proceeds deduction would be *limited* to such a situation.

Further, one of these passing references was in a pamphlet written by the staff of the Joint Committee on Taxation in September 1985. The pamphlet does not purport to speak for Congress or even a congressional committee, and was prepared over a year before passage of the TRA. Its value as legislative history is doubtful. The other passing reference is a floor statement made by Senator Russell Long, which was at best ambiguous.[7] We have no trouble concluding that these two fleeting references – each of which merely stated that section 2057 would encourage decedents to sell their own companies to an ESOP – did not give constructive notice to Carlton that an amendment imposing a decedent ownership requirement would be forthcoming.

Next, we turn to the second important factor, whether Carlton reasonably and detrimentally relied on section 2057 as enacted in 1986. That Carlton specifically relied on the ESOP proceeds deduction contained in the new section 2057 in deciding to pursue the MCI transaction is undoubted. Indeed, the government has so stipulated. While this fact is uncontested, it should not be overlooked. The very fact that Carlton engaged in a

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[7] Interestingly, while the government argues that this statement gave constructive notice to Carlton, the government itself was apparently unaware of it at the time it filed its brief and only brought it to our attention on the eve of oral argument.

costly transaction for no other reason than the inducement provided by the new section 2057 makes this case significantly different from those rejecting a due process challenge to a retroactively applied revenue law.

Indeed, to say that the estate merely "relied" on section 2057 understates the circumstances of this case. The federal government has long sought to promote employee ownership of shares in their employers. Section 2057 was enacted to induce taxpayers to sell shares at a discounted price to an ESOP, thus furthering the public policy of employee ownership. As intended, the Day estate succumbed to the lure and sold shares to the MCI ESOP at a substantial discount. Section 2057 worked. An ESOP was able to buy more shares at a lower price than before. Then, when the private actor had completed the socially desirable action of selling shares at a discount to an ESOP, the government reneged on its end of the deal. It was too late for Carlton to undo his sale to the MCI ESOP. The $631,000 was gone forever, irretrievable.

The government urges, however, that while Carlton's reliance on the ESOP proceeds deduction is undoubted, it was not reasonable. At the core of this argument is the notion that section 2057 as originally enacted was such a windfall, any reasonable taxpayer would have known it was "too good to be true." We flatly reject the government's premise that a taxpayer cannot rely on the clear and unequivocal text of the tax code, but instead must speculate on the unspoken and inchoate intentions of Congress.

Moreover, viewed in the context of the other huge tax incentives that Congress has created to encourage the

development of ESOPs, section 2057 should not have raised any eyebrows, even as first enacted in 1986. According to the Joint Committee on Taxation,

> [t]he tax expenditure for qualified plans is the largest single item of tax expenditures. For the fiscal year 1986, the tax expenditure for employer maintained qualified plans (including Keogh plans) is estimated to be $56.8 billion and this expenditure is projected to increase to $88.9 billion for fiscal year 1990.

Staff of Joint Comm. on Taxation, 99th Cong., 1st Sess., Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs) 21 n. 29 (Comm. Print 1985). The total annual tax expenditure of section 2057 if it had *not* been amended in 1987 was estimated by the Joint Committee on Taxation at $1.4 billion. *See* 133 Cong. Rec. H845 (Feb. 26, 1987) (statement of Rep. Rostenkowski citing the Joint Comm. on Taxation); *id.* at S2532 (statement of Sen. Bentsen citing the Joint Comm. on Taxation). Although ESOPs are just one type of "qualified plan," a term which also includes pension and profit-sharing plans, this tax expenditure of $1.4 billion does not appear incredible in the context of a total tax expenditure to promote employee investment of $56.8 billion. Thus, even if it were reasonable to expect that before a taxpayer would take a deduction plainly available to him under the tax code, he would research the estimated tax expenditure associated with such deduction, the tax expenditure created by the ESOP proceeds deduction as originally enacted was entirely plausible.

Carlton had little reason to think Congress had made a drafting error. After all, the ESOP proceeds deduction

was not added to the TRA in a frenzied last minute effort. Section 2057 had first been proposed over two and a half years before the TRA was finally passed. As approved by the Senate Finance Committee in March 1984, section 2057 did not have a decedent ownership requirement. Sen. Comm. on Finance, 98th Cong., 2d Sess., 2 Deficit Reduction Act of 1984, Statutory Language of Provisions Approved by the Committee on March 21, 1984, at 338 (Comm. Print 1984). Thus, it cannot be seriously argued that the decedent ownership requirement was inadvertently omitted in a last minute drafting error.

Congress has given several substantial tax incentives to ESOPs over the years. When a bank loans money to an ESOP to finance the purchase of shares, half of the interest income from such loans is excluded from taxable income. *See* 26 U.S.C. § 133. Taxpayers who sell shares to an ESOP may defer for tax purposes the recognition of any capital gain on such sale. *See* 26 U.S.C. § 1042. In this context, section 2057's provision allowing half of the proceeds of a sale of shares to an ESOP to be excluded from the taxable estate would not have appeared out of line.

The government nevertheless argues that any reliance by the estate on the new section 2057 was not truly detrimental in any event. This argument has two aspects. First, the government argues that the availability of any deduction under the tax code is an act of legislative grace, and that the 1987 amendment imposing the decedent ownership requirement simply restored the estate to the position it would have been in had Congress not made the "mistake" of passing section 2057 in 1986 without the decedent ownership requirement. This is simply not correct. The estate essentially "paid" $631,000

(plus transactions costs such as brokerage and attorney fees) to receive the $2.5 million reduction in tax liability. Unlike *Welch*, where the tax preference for Wisconsin corporations having been ended the taxpayer was merely restored to the position he would have been in had such preference never been enacted, here, the taxpayer is *not* restored to the status quo ante, but suffers a loss. It is true that the payment of the $2.5 million in taxes makes the estate's *tax liability* no worse than it would have been if the ESOP proceeds deduction had never been enacted in the first place. But this begs the question. It fails to account for the actual loss suffered by the estate. To truly return the estate to the status quo ante, the government would have to pay it $631,000. We are persuaded that this is a critical distinction from *Hemme* where, even with the retroactive application of the new tax statute, the taxpayer was still better off than he would have been under the old regime.

Second, the government contends that a loss by the estate was not a prerequisite under section 2057 to qualify for the ESOP proceeds deduction, and so should not be considered in determining whether retroactive application of the decedent ownership requirement is unduly harsh and oppressive. That is, selling the shares to the ESOP *at a discount* from the market price is not one of the statutorily defined requirements to qualify for the ESOP proceeds deduction.

One need not be an economist, however, to perceive that in practice the only way to have obtained the deduction was for the estate to offer to "share" it with the other party necessary to the transaction, the ESOP. Under section 2057, the estate must file with the IRS certification

from the ESOP that the ESOP meets certain requirements. *See* 26 U.S.C. § 2057(e). Because the ESOP must provide such certification, it necessarily knows the circumstances under which the sale is being made and the substantial tax deduction the estate will be receiving. Moreover, there is no way of going around the ESOP; its cooperation is essential. In this situation, it is manifest that any rational ESOP can and will demand some part of the tax break in the form of a discounted share price. The MCI ESOP had to have some incentive to deal with Carlton, given the extra paperwork required, rather than just purchase its shares on the open market. Selling the shares at a discount from the market price was not an error or miscalculation on Carlton's part, but instead a necessary concession to complete the deal.

We believe that the estate's reliance on the plain language of section 2057 was reasonable in light of the lack of any indication that an amendment was in the offing and in the context of the large tax incentives Congress has given to ESOPs. Further, the detriment to the estate is obvious. The 1987 amendment did not merely restore the status quo before the TRA. The estate was out $631,000.

The government argues that the MCI ESOP transaction was a sham, that it had no substance. We disagree. The substance was in the transfer of wealth from the Day estate to the MCI ESOP. The Day estate was $631,000 poorer after the transaction than it was before. The MCI ESOP now owns more shares than it would have had it only been able to purchase shares on the open market. The permanently changed positions of the parties show that the transaction had substance and reality.

We do not doubt the power of Congress to apply legislation retroactively to the time such legislation was introduced, or even to the time such legislation was proposed by the executive branch. *See Purvis*, 501 F.2d at 313-14 (retroactive application of "interest equalization tax" on American purchases of foreign securities to the time when first proposed by the President does not violate due process). During this time period, the taxpayer is on notice that a change in law is forthcoming. The government has a strong interest in capturing within its taxing powers transactions deliberately rushed through in anticipation of a pending change of law. Our conclusion would likely be entirely different if Carlton had engaged in his transaction after January 5, 1987. *See Ferman v. United States*, 790 F.Supp. 656 (E.D.La.1992) (rejecting claim that decedent ownership requirement was unconstitutionally applied to transaction in February 1987).

Having considered the nature of the 1987 amendment and the circumstances in which it was laid, we conclude that, as applied here, such amendment is "so harsh and oppressive as to transgress the constitutional limitation." Carlton had no notice, actual or constructive. The estate entered into a transaction that cost it over $600,000, based solely on the inducement of a tax deduction the government now wants to take away.

IV

We hold that the 1987 amendment to the federal estate tax imposing a decedent ownership requirement on the ESOP proceeds deduction formerly contained at 26 U.S.C.

§ 2057, as applied to the transaction at issue here, violated the Due Process Clause of the Fifth Amendment. The parties have stipulated that if such amendment could not be retroactively applied to the transaction here consistent with the Constitution, "then the taxpayer is entitled to judgment as sought in the complaint." Accordingly, we reverse the judgment of the district court and remand with instructions to enter judgment in favor of the plaintiff.

REVERSED and REMANDED with INSTRUCTIONS.

NORRIS, Circuit Judge, dissenting:

The majority recognizes that "the modern trend has been against successful challenges to retroactive applications of the tax statutes." Majority at 1057. Indeed, in order to find Supreme Court precedent for striking down retroactive taxation, the majority opinion, like the petitioner's brief, was forced to reach back to the *Lochner* era. My reading of contemporary case law leads me to a different conclusion: Congress did not offend the constitutional requirement of due process when it retroactively applied the "decedent ownership requirement" to an estate tax provision encouraging Employee Stock Ownership Plans (ESOPs). I accordingly dissent.

In regulating economic activity, Congress enjoys wide latitude to legislate retroactively. The Supreme Court explains that

> the strong deference accorded legislation in the field of national economic policy is no less applicable when that legislation is applied retroactively. Provided that the retroactive application of a statute is supported by a legitimate legislative purpose furthered by rational means,

> judgments about the wisdom of such legislation remain within the exclusive province of the legislative and executive branches. . . .

Pension Benefit Guaranty Corp. v. R.A. Gray & Co., 467 U.S. 717, 729, 104 S.Ct. 2709, 2717-18, 81 L.Ed.2d 601 (1984). This principle applies with full force to the tax laws, where courts may step in only when " 'retroactive application is so harsh and oppressive as to transgress the constitutional limitation.' " *United States v. Hemme*, 476 U.S. 558, 568-69, 106 S.Ct. 2071, 2077, 90 L.Ed.2d 538 (1986) (quoting *Welch v. Henry*, 305 U.S. 134, 147, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938)). Measured against this high standard, the 1987 amendment to the Tax Reform Act of 1986 should be upheld.

The facts of *Welch v. Henry* provide an appropriate starting point for interpreting the "harsh and oppressive" standard that the opinion articulates. The taxpayer's income in that case derived mostly from dividends paid by corporations doing a majority of their business in Wisconsin. *Welch*, 305 U.S. at 141, 59 S.Ct. at 122. Wisconsin's income tax statutes treated such dividend income extremely favorably until, in 1935, the state imposed additional taxes, to be applied retroactively to dividends paid in 1933 and 1934. *Id.* at 143, 59 S.Ct. at 124. Although the Court had previously struck down retroactive taxes on gifts, *see Nichols v. Coolidge*, 274 U.S. 531, 47 S.Ct. 710, 71 L.Ed. 1184 (1927), *Blodgett v. Holden*, 275 U.S. 142, 48 S.Ct. 105, 72 L.Ed. 206 (1927), *Untermyer v. Anderson*, 276 U.S. 440, 48 S.Ct. 353, 72 L.Ed. 645 (1928), it upheld this statute on the basis that "a tax on the receipt of income is not comparable to a gift tax," but more properly resembles property taxes and benefit assessments of real estate,

where retroactivity had been found appropriate. *Id.* 305 U.S. at 147-48, 59 S.Ct. at 125-26. The Court reasoned that bestowing a gift is the "voluntary act of the taxpayer," which it contrasted with receiving corporate dividends: "We can not assume that stockholders would refuse to receive corporate dividends even if they knew that their receipt would later be subjected to a new tax or to the increase of an old one." *Id.* Because the decision to invest in stocks whose dividends receive favorable tax treatment is, of course, voluntary, the distinction between the taxpayer in *Welch* and those in *Nichols, Blodgett,* and *Untermyer* lies in the difference between Welch's economic and the others' eleemosynary motives for the acts that gave rise to tax liability. Welch's dividends were a form of consideration in exchange for his investment in Wisconsin corporations, and receipt of consideration was, in the Court's sense of the word, involuntary.

Carlton's case closely resembles Welch's. Carlton structured the financial affairs of Mrs. Day's estate to take advantage of the favorable tax treatment for sales of stock to ESOPs. Likewise, Welch's portfolio had been structured to exploit the special treatment accorded dividends from Wisconsin corporations. In Carlton's case, as in Welch's, the taxing authority that had created the special tax benefits grew concerned about their drain on the public fisc and retroactively eliminated them. In Welch's case, the retroactive law was a sharp departure from a long history of favorable treatment for investments in Wisconsin corporations. *Welch,* 305 U.S. at 142-43, 59 S.Ct. at 123. Carlton's case is arguably less sympathetic because the retroactive law, in closing a loophole in the

ESOP deduction provision, merely restored the status quo that Carlton faced a year earlier.

Cases decided since *Welch* have upheld retroactive taxes on a variety of economic transactions, sharply limiting the scope of the *Lochner*-era cases. *See, e.g., United States v. Hemme*, 476 U.S. 558, 106 S.Ct. 2071, 90 L.Ed.2d 538 (1986) (retroactive application of the transitional rule for federal gift and estate taxes upheld); *United States v. Darusmont*, 449 U.S. 292, 101 S.Ct. 549, 66 L.Ed.2d 513 (1981) (per curiam) (retroactive increase in the minimum tax upheld); *Wiggins v. Commissioner*, 904 F.2d 311 (5th Cir.1990) (upheld retroactive exclusion of investment tax credit recapture when calculating alternative minimum tax); *Estate of Ekins v. Commissioner*, 797 F.2d 481 (7th Cir.1986) (retroactive repeal of an estate tax exclusion for life insurance policies upheld); *Fein v. United States*, 730 F.2d 1211 (8th Cir.), *cert. denied*, 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984) (same); *Estate of Ceppi v. Commissioner*, 698 F.2d 17 (1st Cir. 1983), *cert. denied*, 462 U.S. 1120, 103 S.Ct. 3088, 77 L.Ed.2d 1350 (1983) (retroactive repeal of estate tax exclusion upheld); *Westwick v. Commissioner*, 636 F.2d 291 (10th Cir.1980) (retroactive changes in the minimum tax upheld in spite of detrimental reliance); *Purvis v. United States*, 501 F.2d 311 (9th Cir.), *cert. denied*, 420 U.S. 947, 95 S.Ct. 1329, 43 L.Ed.2d 425 (1975) (interest equalization tax on foreign stock acquisitions may be retroactively applied); *First National Bank in Dallas v. United States*, 420 F.2d 725, 190 Ct.Cl. 400 (1970) (same); *Sidney v. Commissioner*, 273 F.2d 928 (2d Cir.1960) (Friendly, J.) (retroactive taxation of gains realized from collapsible corporations upheld).

Most of these cases have limited *Nichols*, *Blodgett*, and *Untermyer* to their facts, or at least to retroactive imposition of a wholly new tax, as opposed to a change in the base or rate of an existing tax. *Hemme*, 476 U.S. at 568, 106 S.Ct. at 2077; *Darusmont*, 449 U.S. at 299, 101 S.Ct. at 553; *Wiggins*, 904 F.2d at 314; *Estate of Ekins*, 797 F.2d at 484; *Fein*, 730 F.2d at 1213; *Estate of Ceppi*, 698 F.2d at 21; *Westwick*, 636 F.2d at 292; *First Nat'l Bank in Dallas*, 420 F.2d at 730 n. 8; *Sidney*, 273 F.2d at 932. The Ninth Circuit decided *Purvis v. United States* on the narrower ground that a presidential speech proposing the retroactive tax had put the taxpayer on notice of the subsequent change, so that retroactive application was not "harsh and oppressive." 501 F.2d at 314-15.

The Supreme Court and our sister circuits have made clear, however, that constructive notice to the taxpayer is usually implied for a change in the rate or basis of an existing tax. In the words of the Seventh Circuit, "a change in the tax rate is considered by its very nature to be reasonably foreseeable." *Estate of Ekins v. Commissioner*, 797 F.2d 481, 484 (7th Cir. 1986). "Legislative changes are to be expected, and the taxpayer assumes the risk that the tax burden on a particular transaction may increase pursuant to Congress' continual responsibility to carry out the necessary policies of taxation." *Id.* at 483 (citing *Milliken v. United States*, 283 U.S. 15, 23, 51 S.Ct. 324, 327, 75 L.Ed. 809 (1931)). *Accord Fein v. United States*, 730 F.2d 1211, 1213 (8th Cir.), *cert. denied*, 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984). Our court once considered the point so obvious that it disposed of a challenge to retroactive repeal of an income tax loss carry-forward provision in a single paragraph. We called that tax provision "a

matter of legislative grace . . . within the power of Congress to revoke" retroactively. *Miller v. Commissioner*, 115 F.2d 479, 480 (9th Cir.1940). Under this analysis, we should imply constructive notice of the tax code amendment, which retroactively abolished the fifty percent deduction for proceeds from an ESOP stock sale but levied no wholly new taxes. The majority, in reaching a different conclusion, creates a split among the circuits, as well as a conflict with our own, older precedent.

In addition to taxes that are wholly new and therefore completely unforeseeable, the Supreme Court has suggested that retroactive taxes that "attempt to reach events [too] far in the past" are harsh and oppressive. *Welch v. Henry*, 305 U.S. 134, 148, 59 S.Ct. 121, 126, 83 L.Ed. 87 (1938). Congress has long enacted revenue laws that retroactively tax income and assets from the entire year in which the new statute is passed, and in some instances from the calendar year preceding the year of the new legislation's enactment. *United States v. Darusmont*, 449 U.S. 292, 296, 101 S.Ct. 549, 551, 66 L.Ed.2d 513 (1981) (per curiam). The courts have upheld this "customary congressional practice" as "required by the practicalities of producing national legislation." *Id.* at 297, 101 S.Ct. at 552. The circuits have split on whether retroactive taxes may reach back before the calendar year that precedes the year of their enactment. Curative legislation, passed to effectuate the original intent of Congress, has been granted greater leeway. *See, e.g. New England Baptist Hospital v. United States*, 807 F.2d 280, 285 (1st Cir.1986) (four years of retroactive effect upheld for curative legislation); *accord Canisius College v. United States*, 799 F.2d 18, 26-27 (2d Cir.), *cert. denied*, 481 U.S. 1014, 107 S.Ct. 1887,

95 L.Ed.2d 495 (1987); *accord Temple University v. United States*, 769 F.2d 126, 135 (3d Cir.), *cert. denied*, 476 U.S. 1182, 106 S.Ct. 2914, 91 L.Ed.2d 544 (1986); *cf. Wheeler v. Commissioner*, 143 F.2d 162, 166 (9th Cir.), *rev'd on other grounds*, 324 U.S. 542, 65 S.Ct. 799, 89 L.Ed. 1166 (1945) (tax statute with two years' retroactive application struck down). We need not reach that dispute here, however, where the period of retroactive application for the revenue measure includes the calendar year in which it was passed and only a few months of the preceding year.[1]

The majority's opinion substitutes a test much more sympathetic to the taxpayer than those that courts have used in the past. It asks (1) whether the taxpayer had actual or constructive notice of the specific retroactive provision, and (2) whether the taxpayer reasonably relied to his detriment on the tax code as written at the time of his transaction. While maximum fairness to taxpayers might argue that Congress should legislate according to this generous standard, the Supreme Court has declined to adopt it as a requirement of Due Process.

The taxpayer in *Darusmont* suggested two tests that resemble those the majority uses here. First he asked, could the taxpayer "have altered his behavior to avoid the tax if it could have been anticipated by him at the time the transaction was effected?" 449 U.S. at 299, 101 S.Ct. at 553. The majority's inquiry into detrimental

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[1] The amendment retroactively applying the decedent ownership requirement was introduced in the 100th Congress on February 26, 1987. It became law on December 22, 1987, and applied as of October 22, 1986, the day when the Tax Reform Act it modified was originally enacted.

reliance is the same test more elegantly stated, but the Supreme Court rejected it as based on the old gift tax cases, which had no precedential value for retroactive taxes on income. *Id.* Detrimental reliance is essentially a creature of contract law, where the theory of promissory estoppel vests rights in a party that reasonably relies on another's promise. Restatement (Second) of Contracts § 90 (1981). Contractual analogies, the Supreme Court tells us, are inapposite in tax cases:

> '[t]axation is neither a penalty imposed on the taxpayer nor a liability which he assumes by contract. It is but a way of apportioning the cost of government among those who in some measure are privileged to enjoy its benefits and must bear its burdens. Since no citizen enjoys immunity from that burden, its retroactive imposition does not necessarily infringe due process, and to challenge the present tax it is not enough to point out that the taxable event. . . antedated the statute.'

United States v. Darusmont, 449 U.S. 292, 298, 101 S.Ct. 549, 552, 66 L.Ed.2d 513 (1981) (per curiam) (quoting *Welch v. Henry*, 305 U.S. 134, 146-47, 59 S.Ct. 121, 125, 83 L.Ed. 87 (1938)).

Darusmont's second test was whether the taxpayer lacked "actual or constructive notice" of the retroactive legislation. The Court's per curiam opinion did not directly address the appropriateness of this inquiry, as the facts of Darusmont's case indicated notice aplenty. The Court did, however, cite approvingly a couple of its earlier cases upholding retroactive taxation where notice had not been demonstrated. *Id.* 449 U.S. at 299, 101 S.Ct. at 553 (citing *Welch v. Henry*, 305 U.S. 134, 59 S.Ct. 121, 83

L.Ed. 87 (1938)), *Id.* 449 U.S. at 300, 101 S.Ct. at 553 (citing *Cooper v. United States,* 280 U.S. 409, 50 S.Ct. 164, 74 L.Ed. 516 (1930)). And two other circuits have interpreted an earlier Supreme Court case as inferring constructive notice whenever a tax code revision alters the rate or basis for an existing tax. *Estate of Ekins v. Commissioner,* 797 F.2d 481, 483 (7th Cir. 1986) (citing *Milliken v. United States,* 283 U.S. 15, 23, 51 S.Ct. 324, 327, 75 L.Ed. 809 (1931)); *accord Fein v. United States,* 730 F.2d 1211, 1213 (8th Cir.), *cert. denied,* 469 U.S. 858, 105 S.Ct. 188, 83 L.Ed.2d 121 (1984).

In any event, were I to apply the majority's test to this case, I would be less willing to find that, at the time he arranged the purchase and sale of MCI stock, Carlton lacked constructive notice that a future retroactive amendment might render the Day estate ineligible for the ESOP deduction. Nor would I find his reliance on the statute as originally passed to have been reasonable. True, the plain language of the 1986 provision allowed Carlton to benefit from the transaction he arranged. But several factors indicated that Congress would not be satisfied with its original work and might act to curtail the benefit within a short time after its enactment.

First, the available legislative history indicates that the original intent of Congress had been to allow "stockholders to sell their companies to their employees who helped them build the company." Staff of the Joint Committee on Taxation, 99th Cong., 2d Sess., *Tax Reform Proposals: Tax Treatment of Employee Stock Ownership Plans (ESOPs)* at 37 (Comm. Print 1985). The majority correctly points out that this statement highlights a class of decedent owners, but does not *limit* the deduction to them. If,

however, Congress had meant to allow any estate willing to undertake a relatively low-risk securities transaction to benefit from the ESOP proceeds deduction, then examples of decedent owners selling to their employees would be an infinitesimal proportion, not a prototypical example, of the beneficiaries of the rule. Any estate executor would have difficulty resisting the temptation to purchase securities on the open market and promptly resell them at below market to an ESOP in order to reduce estate taxes. Had Congress understood the scope of the provision it had drafted, the measure's opponents would surely have raised more important concerns than the tracing problems for lifetime sales that the legislative history mentions as the chief argument against the deduction. *Id.* The estimated revenue loss from the estate tax provision as drafted – some $7 billion – was more than 20 times the $300 million loss Congress had contemplated. Appellee's Brief at 26.

Second, the statute on its face offered a benefit that appeared "too good to be true." Admittedly, a number of laws provide tax incentives to encourage the growth of ESOPs, in some cases subsidizing third parties for facilitating the transfer of employer securities to an ESOP. For example, a 1984 provision gives a taxpayer who sells an ESOP stock in a closely held corporation the right to roll over his or her capital gains by reinvesting in other securities. 26 U.S.C. § 1042. Although this provision gives the taxpayer an incentive to sell to an ESOP rather than on the open market, it offers those who sell to ESOPs no tax advantages over those who continue to hold their original investment, and thus should cost the U.S. Treasury little. Another provision that benefits ESOPs through

subsidies to third parties allows a bank to exclude from taxation fifty percent of interest income for any loan made to an ESOP. 26 U.S.C. § 133. Note that the loss to the Treasury from this provision leverages tremendous funds: At a ten percent interest rate, every nickel of tax base the Treasury loses lands a dollar in the pocket of an ESOP. In contrast, the estate tax provision that Carlton employs saps fifty cents of estate tax base without guaranteeing *any* benefit for the ESOP. True, the ESOP's bargaining leverage should enable it to shave off for itself a piece of the estate's tax benefit. But the outcome of this case, where the ESOP saved $631,000 in purchasing employer stock, while the Treasury lost $2,501,161 in estate taxes, demonstrates that the deduction as drafted offered a subsidy of a wholly different magnitude from existing provisions. Congress could more providently have underwritten ESOP stock purchases directly from the U.S. Treasury without bringing in estate executors as middlemen!

I recognize that, if this case raised a question of statutory interpretation, neither the provision's legislative history nor its unfortunate economic effects could detract from the plain meaning of the text. *See Connecticut Nat'l Bank v. Germain*, ___ U.S. ___, at ___, 112 S.Ct. 1146, at 1149, 117 L.Ed.2d 391 (1992). But this case does not require us to interpret the 1986 statute, only to inquire whether Congress, in amending it, acted in an arbitrary and capricious manner, or "so harsh[ly] and oppressive[ly] as to transgress the constitutional limitation." *Pension Benefit Guaranty Corp. v. R.A. Gray & Co.*, 467 U.S. 717, 733, 104 S.Ct. 2709, 2719, 81 L.Ed.2d 601 (1984). Because Congress's retroactive legislation limited the

scope of a loophole that had been in effect just over one year, it did not transgress that boundary.

APPENDIX D

SEC. 2057. SALES OF EMPLOYER SECURITIES TO EMPLOYEE STOCK OWNERSHIP PLANS. . . .

(a) GENERAL RULE. – For purposes of *the tax* imposed by section 2001, the value of the taxable estate *shall be determined by deducting* from the value of the gross estate *an amount equal to 50 percent of the qualified proceeds of a qualified sale* of employer securities.

(b) QUALIFIED SALE. – For purposes of this section, the term *'qualified sale' means any sale of employer securities by the executor of an estate to* –

(1) *an employee stock ownership plan* is [sic] described in section 4975(e)(7). . . .

(c) QUALIFIED PROCEEDS. – For purposes of this action –

(1) IN GENERAL. – The term *'qualified proceeds' means the amount received* by the estate from the sale of employer securities at any time *before the date on which the [estate tax] return . . . is required to be filed (including any extensions).*

* * *

(d) WRITTEN STATEMENT REQUIRED. –

(1) IN GENERAL. – *No deduction shall be allowed* under subsection (a) *unless the executor* of the estate of the decedent *files* with the Secretary the statement described in paragraph (2).

(2) STATEMENT. – A statement is described in this paragraph if it is *a verified written statement of* –

(A) *the employer* whose employees are covered by the plan described in subsection (b)(1) . . .

consenting to the application of section 4979A with respect to such employer or cooperative. (Emphasis added.)

APPENDIX E

Section 10411. CONGRESSIONAL CLARIFICATION OF ESTATE TAX DEDUCTION FOR SALES OF EMPLOYER SECURITIES.

(a) *Intent of Congress in Enacting Section 2057 of the Internal Revenue Code of 1986.* – Section 2057 (relating to sales of employer securities to employee stock ownership plans or worker-owned cooperatives) is amended by redesignating subsections (d), (e), and (f) as subsections (e), (f), and (g), respectively, and by inserting after subsection (c) the following new subsection:

* * *

(d) *Qualified Proceeds From Qualified Sales.* –

(1) *In general.* – For purposes of this section, the proceeds of a sale of employer securities by an executor to an employee stock ownership plan or an eligible worker-owned cooperative shall not be treated as qualified proceeds from a qualified sale unless –

(A) the decedent directly owned the securities immediately before death, . . .

* * *

(b) *Effective Date.* – The amendments made by subsection (a) shall take effect as if included in the amendments made by section 1172 of the Tax Reform Act of 1986.

APPENDIX F

UNITED STATES DISTRICT COURT

EASTERN DISTRICT OF LOUISIANA

BERTHA PAGLIN FERMAN, EXECUTRIX OF THE ESTATE ESTATE [sic] OF JULES J. PAGLIN	*	CIVIL ACTION NO. 90-1878
	*	SECTION "K"
V.	*	MAGISTRATE 3
UNITED STATES OF AMERICA	*	(Filed Feb. 3, 1992)

****

JOINT STIPULATION OF FACTS

Plaintiff and Defendant stipulate that the following facts are true:

1. On October 22, 1986, New IRS § 2057 was enacted as part of the Tax Reform Act of 1986. P.L. 99-514, § 1172.

2. On October 27, 1986, the decedent Jules J. Paglin died testate at his domicile in the Parish of Orleans, State of Louisiana.

3. On October 29, 1986, the will of Jules J. Paglin was probated and Bertha Paglin Ferman qualified as Testamentary Executrix in proceedings styled "Succession of Jules J. Paglin," Docket No. 86-19726 of the Civil District Court for the Parish of Orleans, State of Louisiana. Mrs. Ferman is the principal beneficiary under the decedent's will. If she were called to testify in this case, Mrs. Ferman would characterize herself as a "sophisticated investor." She would admit to being a conservative investor. She would testify that she and her husband have substantial

investments for their own account. She and her husband, Professor Irving Ferman, at one time invested in stocks. She would state that by February of 1987, she and her husband had decided to liquidate and to refrain from any further investment in common stocks for their own account. The reason that the Fermans decided to get out of the stock market is that they foresaw a substantial risk of downturn in the stock market.

4. At the date of his death, Jules J. Paglin owned shares of stock of over 75 publicly traded corporations. His portfolio was diverse: when he died, Mr. Paglin did not own more than $25,000 worth of stock of any one company, with one exception. At the date of his death, the decedent owned 100 shares of ALZA Corporation Class A common stock. These shares were included on Schedule B, Item 39 of the United States Estate Tax Return (U. S. Treas. Form 706) as follows:

100 shares of ALZA Corporation Class A Common stock, American Exchange, CUSIP No. 02261510		
Valued at	20.3125	$ 2,031.25

These shares continue to be retained in a custodianship account at Hibernia National Bank. Jules J. Paglin had no legal relationship to the ALZA Employee Stock Ownership Plan (ALZA ESOP).

5. The ALZA Corporation is a publicly traded company. Its shares of stock are listed for sale on the American Stock Exchange. Its principal place of business is in Palo Alto, California.

6. On January 5, 1987, the Internal Revenue Service issued Notice 87-13, including specifically Question and Answer 23, published in IRB 1987-4.

7. On or before February 20, 1987, Bertha Paglin Ferman, in her capacity as Testamentary Executrix of the Succession of Jules J. Paglin, opened Account No. 112-088801 and deposited $350,000 in cash funds through Jeffrey Traum of the office of Dean, Witter, Reynolds, Inc. of Palo Alto, California, on or before February 20, 1987, for the purpose of transactions involving the acquisition and immediate subsequent sales of Class A common stock of ALZA Corporation. Prior to this transaction, neither Mrs. Ferman nor her husband Irving had met Mr. Traum. Neither had Mr. Paglin during his life. Prior to this transaction, neither of the Fermans had an account at Dean, Witter, Reynolds, Inc., and furthermore, neither had Mr. Paglin.

8. The Trustees of the ALZA Corporation Employee Stock Ownership Plan (ALZA ESOP) executed the following Stock Purchase Agreements for the purchase from the Estate of Jules J. Paglin of Class A common stock of ALZA Corporation.

A. The Stock Purchase Agreement between the Estate of Jules J. Paglin and the Trust established under that certain Trust Agreement Under the ALZA Corporation Employee Stock Ownership Plan executed on February 20, 1987.

B. The Stock Purchase Agreement between the Estate of Jules J. Paglin and the Trust established under that certain Trust Agreement. Under the ALZA Corporation Employee

Stock Ownership Plan executed on February 23, 1987.

C. The Stock Purchase Agreement between the Estate of Jules J. Paglin and the Trust established under that certain Trust Agreement Under the ALZA Corporation Employee Stock Ownership Plan executed on February 24, 1987.

9. The Estate of Jules J. Paglin, pursuant to these contractual undertakings described in Paragraph 8 of this Stipulation, purchased in its Account No. 112-088801 the following shares of ALZA Corporation Class A common stock for immediate subsequent sale on the same date to the ALZA ESOP in its Account No. 112-87822:

Date of Stock Purchase Agreement	Date of Purchase of ALZA Stock Account No. 112-088801	Date of Sale to ALZA ESC Account N 11208782
2/20/87	2/20/87	2/20/87
2/23/87	2/23/87	2/23/87
2/24/87	2/24/87	2/24/87
	Totals	

Number of Shares	Sale Prices to ALZA ESOP
12,300	$329,175.00
12,200	$310,317.50
11,200	$292,600.00
35,700	$932,092.50

10. The purchase prices paid by the Estate for the 35,700 shares of ALZA stock aggregate $981,150, plus aggregate brokerage commissions of $7,000, for a total cost to the Estate of $988,150. The total prices paid by the ALZA ESOP to the Estate was $932,092.50, resulting in an aggregate discount as follows:

Transaction Date	Total Cost	ESOP Transaction	Discount
2/20/87	$348,960.00	$329,175.00	$17,325.00
2/23/87	$329,090.00	$310,317.50	$16,332.50
2/24/87	$310,100.00	$292,600.00	$15,400.00
Totals	$988,150.00	$932,090.50	$49,057.50

Therefore, the Estate of Jules J. Paglin sold 35,700 shares of Class A common stock of ALZA Corporation to the ALZA ESOP, as reflected above during the period from February 20, 1987 through February 24, 1987, at a loss of $49,057.50.

11. David R. Hoffman, an authorized Vice-President of ALZA Corporation, executed the consents required by The Tax Reform Act of 1986 as follows:

A. The letter dated February 20, 1987 from David R. Hoffman, Vice-President of ALZA Corporation, reflecting the consent relating to the purchase on that date by the ALZA ESOP.

B. The letter dated February 23, 1987 from David R. Hoffman, Vice-President of ALZA Corporation, reflecting the consent relating to the purchase on that date by the ALZA ESOP.

C. The letter dated February 24, 1987 from David R. Hoffman, Vice-President of ALZA

Corporation, reflecting the consent relating to the purchase on that date by the ALZA ESOP.

12. The Testamentary Executrix purchased the 35,700 shares of stock of the ALZA Corporation within a three-business day period, and resold those same identical shares within the same three-business day period, for only one reason: she had been advised by her attorneys that by purchasing and reselling, purchasing and reselling, and purchasing and reselling the stock to an ESOP, the estate could be entitled to a tax deduction under New IRS §2057. The effect of the tax deduction would be to reduce the gross estate, thereby resulting in a reduction in the amount of estate taxes due to be paid. The Testamentary Executrix' decision to purchase these shares of ALZA stock, pay the commissions due on the purchase, and resell the stock at a discount, was purely tax motivated. Her decision to purchase shares of ALZA Corporation was motivated not at all by the attributes of that company. The only reason that the estate purchased ALZA stock, as opposed to the stock of another company, was the fact that the ALZA ESOP had by prior agreement agreed to purchase at a discount the entire quantity of ALZA Corporation stock directly from the estate, and the ALZA ESOP agreed to make the purchase from the estate over the three-day period. Other corporations that had ESOPs were contacted by Mr. Ferman prior to February 20. The ALZA ESOP agreed to purchase the shares at a lower discount than did the other ESOPs, and therefore the Executrix chose to do business with the ALZA ESOP instead of with another ESOP.

13. On or about July 17, 1987, the Testamentary Executrix timely filed the United States Estate Tax Return (U.S. Treas. Form 706) by mailing the return to the Internal Revenue Service Center in Austin, Texas. The decedent's federal estate tax return reflected a total gross estate of $2,786,691.42, with total allowable deductions of $916,852.39, resulting in a taxable estate of $1,869,839.03. The brokerage commissions incurred in the purchases and resales of the ALZA stock in the amount of $7,000, as set forth in Paragraph 10 of the Stipulation were deducted as an administrative expense on Schedule J (Funeral Expenses and Expenses Incurred in Administering Property Subject to Claims), Part B (Administrative Expenses), Subpart 4 (Miscellaneous Expenses), Item (h) described as "Commissions on purchase of ALZA Corporation stock." The fees of the attorneys and accountants incident to evaluation of Section 2057 and the purchases and resales of the ALZA stock described in Paragraphs 9 and 10 of this Stipulation did not constitute a part of the Claim for refund of estate taxes based upon the ALZA ESOP transactions. The federal estate tax return mailed to the Internal Revenue Service Center was accompanied by a check dated July 17, 1987 drawn on the account of the Testamentary Executrix at Hibernia National Bank in satisfaction of the federal estate tax reflected on the return in the amount of $511,097.55.

14. The effect of the purchases of the ALZA stock and the immediate resales of the ALZA stock to the ALZA ESOP through the firm of Dean, Witter, Reynolds, Inc. was to reduce the taxable estate from $1,869,839.03 to $1,403,792.78, or a reduction of the taxable estate in the amount of $466,046.25. The result of the adjustment of the

taxable estate was a reduction of the federal estate tax from $511,097.55 to $333,735.52, resulting in the Claim for refund in the amount of $177,362.03. The precise computation of the amount of the reduction of the federal estate tax is reflected on the schedule filed as Exhibit F annexed to the Claim for refund, filed as an exhibit annexed to the Complaint in these proceedings on March 25, 1990.

15. On December 15, 1987, the Testamentary Executrix, filed a Claim for refund of estate taxes (U. S. Treas. Form 843) in the amount of $177,362.03 on the basis of the schedule annexed to the refund claim as Exhibit F.

16. On January 31, 1990, the Internal Revenue Service disallowed the refund claim in full by letter, accompanied by the Revenue Agent's Report dated December 11, 1989.

17. On September 22, 1989, the Internal Revenue Service Private Letter Ruling 8952003 was issued as Technical Advice Memorandum. The Private Letter Ruling reaffirms the provisions of Notice 87-13.

18. On December 22, 1987, IRC §2057 was retroactively amended and repealed by Section 7304(a)(3) of the Omnibus Budget Reconciliation Act of 1987. P.L. 100-203, §10411.

19. On April 27, 1989, the Internal Revenue Service issued an Estate Tax Closing Letter, indicating that "the federal estate tax return . . . has been accepted as filed."

20. On May 5, 1990, the Testamentary Executrix instituted this proceeding for refund of federal estate taxes.

Respectfully submitted,

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/s/ Paul O. H. Pigman,
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APPENDIX G

Summary of ESOP Benefits

1. Under ERISA at the time, ESOPs were exempt from the general requirement that not more than ten percent of a retirement plan's assets may be invested in the stock of the employer. 29 U.S.C. §§ 1104(a)(2), 1107(b)(1), 1107(d)(3).

2. An employer's sale of stock to its ESOP was exempt from the generally-applicable prohibited transaction rules. 29 U.S.C. § 1108(e); 26 U.S.C. § 4975(d)(13). An employer also was allowed to make loans and guarantee third-party loans to its ESOP that are used to purchase employer stock, thereby dramatically increasing the amount of stock an ESOP can purchase. 29 U.S.C. § 1108(b)(3); 26 U.S.C. § 4975(d)(3). These provisions for "leveraged" ESOP stock purchases illustrate the "boost" the government had provided ESOPs. Repayment of ESOP loans was financed through fully-deductible employer contributions – effectively allowing the employer to finance both principal and interest of the loans with pre-tax corporate income. 26 C.F.R. § 54.4975-7(b) (1977); 26 U.S.C. § 404(a)(9). As a corporate finance device, the potential tax benefit was almost unlimited; the deduction for repayment of principal was limited only by 25 percent of the participant's *entire* payroll and the deduction for payment of interest was unlimited. 26 U.S.C. §§ 404(a)(9)(A), 415(c)(1)(A), 404(a)(9)(B), 415(c)(6)(B).

3. Under the Tax Reduction Act of 1975, Pub. L. No. 94-12, 89 Stat. 26, superseded by the Economic Recovery Tax Act of 1981, Pub. L. No. 98-34 § 1(a), 95 Stat. 172, a corporate employer was entitled to a one percent addition to its ten percent investment tax credit for an equivalent contribution to its ESOP. (In

other words, the government paid 100 percent of the ESOP contribution!) 26 U.S.C. § 46(a)(1)(B).

4. The Economic Recovery Tax Act of 1981 replaced the additions to the investment tax credit described in prior legislation with a tax credit of up to one-half percent of total participant payroll. 26 U.S.C. § 41(a)(2) (until repealed by the TRA). (The government is still bearing the cost on a dollar-for-dollar basis, but the "base" was shifted from investment in capital equipment to the payroll of the employees who are participants in the ESOP.) While one-half percent is a small fraction, total payroll costs provide an extraordinarily large "base" for determining the amount of the government subsidy.

5. The 1984 Act augmented the provisions of the 1976 Act described above by allowing a corporate income tax deduction for dividends paid to an ESOP that are passed-through to participants. 26 U.S.C. § 404(k)(2)(A)-(B). (This eliminated the generally-applicable "double tax" [once at the corporate level and once at the plan participant level] as a part of a corporation's earnings.)

6. The 1984 Act provided an income tax exclusion for banks of one-half of the interest income in an unlimited amount from ESOP loans, 26 U.S.C. § 133, without specifying how much of the tax benefit had to be shared with the ESOP participants through a discount in the interest rate.

7. The 1984 Act permitted persons who sell stock in a closely-held company to an ESOP to defer tax on an unlimited amount of capital gain by reinvesting the proceeds of the sale in other securities, 26 U.S.C. § 1042, without specifying how much of the expected tax benefit had to be shared with the ESOP participants through a discount in the sales price.

8. Until repealed in 1989, the 1984 Act permitted an ESOP to assume the estate tax obligation attributable to stock in the sponsoring employer for a shareholder who transferred the stock to the ESOP, provided the employer guaranteed the payment of tax. 26 U.S.C. § 2210 (before repeal in 1989). (The effect of this provision was to allow the corporation to pay an unlimited amount of estate tax with pre-income tax dollars, rather than the shareholder having to pay the tax with the much smaller net proceeds of corporate income after it has been taxed first at the corporate level and then [as a dividend] at the shareholder level; its purpose was to encourage bargain sales to ESOPs.)

9. The TRA repealed the tax credit funding of ESOPs with a direct dollar-for-dollar tax subsidy, but added a corporate income tax deduction for dividends paid on stock held by an ESOP when those dividends are applied to the repayment of a loan used to acquire employer securities. 26 U.S.C. § 404(k)(2)(C). (By eliminating the corporate-level tax on income used to finance ESOP stock purchases [as well as deferring the tax at the participant level], this provision further encourages a corporate employer to "leverage" its ESOP contribution by guaranteeing repayment of a loan to the ESOP while providing the funds to service the debt out of pre-tax corporate income).

10. The TRA extended the unlimited 50 percent interest income exclusion of the 1984 Act described above to regulated investment companies, as well as banks. 26 U.S.C. § 133(a)(4).